An examination and assessment of mandatory financial instruments disclosures

Submitted by Matthew Alan Bamber to the University of Exeter as a thesis for the degree of Doctor of Philosophy in Accounting in January 2011

This thesis is available for Library use on the understanding that it is copyright material and that no quotation from the thesis may be published without proper acknowledgement.

I certify that all material in this thesis which is not my own work has been identified and that no material has previously been submitted and approved for the award of a degree by this or any other University.

Signature: ...........................................................................................................
Abstract
This study has investigated mandatory disclosure requirements of financial instruments. A first-time adoption compliance review has been undertaken for the FTSE 100 non-financial IFRS 7 compliant firms. In contrast to prior studies, the results reveal that disclosure levels were high, and in some cases firms produce more disclosure than mandatorily required. As recent reviews of disclosure have shown, extant research lacks a coherent definition of quality that links to the original motivations for financial reporting. An argument has been built for adopting compliance levels as an appropriate proxy for the quality of disclosure. This study tests this definition via key stakeholders’ views both ex-ante and ex-post. A combination of content analysis of comment letters, survey data and semi-structured interviews was adopted. Though there is some evidence to the contrary, by and large, it seems that this definition of quality carries a level of integrity. Following this, a determinants study was undertaken investigating what factors drove the quality and quantity of these disclosures. It was found that higher levels of visibility (news stories versus analysts following), a share issue during the year and a higher volume of derivative assets held were statistically significant to quality. Those determinants significant to quantity were lower levels of managerial ownership and higher levels of news stories versus analyst following. However, of greater interest was the finding that the determinants of the quantity of disclosures were different to quality – and often in opposition. Thus, for the first time in a mandatory reporting environment, the findings cast doubt over the appropriateness of researchers adopting quantity as a proxy for quality. Finally, prior literature has shown that accounting standards requirements can be biased towards certain user groups as a result of the lobbying process. If this was the case for IFRS 7 then the compliance results presented could be unfairly skewed as proposals might be adopted to benefit those stronger lobbyists. It is pleasing to note that this study found that the IASB appears to have approached all groups’ responses fairly and appropriately. However, it should be noted that the evidence suggests that if the geographical origin of a response was from either the UK or from outside of the remaining countries of Europe and the US there was a significantly lower chance of the proposed amendment(s) being accepted. This study contributes to the literature by presenting results from a first full review of financial instruments reporting under IFRS 7, and by providing evidence that full, partial, non- and over-compliance are most likely explained by legitimacy
theory, impression management and proprietary costs theory. In addition, this is the first study to review key stakeholders’ attitudes towards the financial instruments reporting requirements, thus helping to justify using the level of compliance as an appropriate measure of quality, whilst providing a cautionary conclusion about the possible inappropriateness of adopting quantity as a proxy.
## Contents

<table>
<thead>
<tr>
<th>List of tables and figures</th>
<th>x</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acknowledgements</td>
<td>xii</td>
</tr>
<tr>
<td>Author’s declaration</td>
<td>xiii</td>
</tr>
</tbody>
</table>

### Chapter 1: Introduction

<table>
<thead>
<tr>
<th>1.1 The importance of reporting financial instruments and their associated risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1.1 Financial instruments: Definitions</td>
</tr>
<tr>
<td>1.1.2 Financial instruments: Use, misuse, abuse and disclosure</td>
</tr>
<tr>
<td>1.1.3 The sample for this study: An introduction and key data</td>
</tr>
<tr>
<td>1.1.4 Research questions</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>1.2 The purposes of disclosure</td>
</tr>
<tr>
<td>1.2.1 Auditors and high levels of disclosure</td>
</tr>
<tr>
<td>1.2.2 Preparers and high levels of disclosure</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>1.3 Compliance issues</td>
</tr>
<tr>
<td>1.3.1 Prior compliance work</td>
</tr>
<tr>
<td>1.3.2 Compliance with financial instruments accounting standards</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>1.4 The determinants of disclosures</td>
</tr>
<tr>
<td>1.4.1 The determinants of IAS/IFRS disclosures</td>
</tr>
<tr>
<td>1.4.2 The determinants of financial instruments disclosures</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>1.5 Mandatory reporting: An introduction</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>1.6 The development of the mandatory financial instruments disclosures</td>
</tr>
<tr>
<td>1.6.1 Background</td>
</tr>
<tr>
<td>1.6.2 Accounting standard setters: The development of financial instruments disclosures and IFRS 7</td>
</tr>
<tr>
<td>1.6.3 IFRS 7 requirements: Introduction</td>
</tr>
<tr>
<td>1.6.3.1 IFRS 7: Background and scope</td>
</tr>
<tr>
<td>1.6.3.2 Objective of IFRS 7</td>
</tr>
<tr>
<td>1.6.3.3 Hedging and hedge accounting</td>
</tr>
<tr>
<td>1.6.3.4.1 Hedge accounting disclosures requirements</td>
</tr>
<tr>
<td>1.6.3.4.2 Why might entities choose not to apply hedge accounting?</td>
</tr>
</tbody>
</table>

### Chapter 2: Literature review

<table>
<thead>
<tr>
<th>2.1 Introduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.2 An overview: Financial instruments reporting requirements</td>
</tr>
<tr>
<td>2.2.1 Background</td>
</tr>
<tr>
<td>2.2.2 Financial instruments: The reporting problem</td>
</tr>
<tr>
<td>2.2.3 The bridge between voluntary and mandatory disclosures and the rationale for mandating reporting requirements</td>
</tr>
<tr>
<td>2.2.4 The impact of mandatory disclosure requirements on the qualitative characteristics and accounting</td>
</tr>
</tbody>
</table>

Page iv
Chapter 3: Chapter 3 Research methodology: The epistemological, ontological and axiological considerations

3.1 Introduction

3.2 Research philosophy: Background

3.3 Research strategies – mixed methods approach

3.4 The approaches adopted
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.4.1 The quantitative approach</td>
<td>119</td>
</tr>
<tr>
<td>3.4.2 The qualitative approach</td>
<td>121</td>
</tr>
<tr>
<td>3.5 Conclusion</td>
<td>122</td>
</tr>
<tr>
<td>Chapter 4: Mandatory reporting compliance issues and a suggested</td>
<td>123</td>
</tr>
<tr>
<td>Rationale</td>
<td>182</td>
</tr>
<tr>
<td>4.1 Introduction</td>
<td>126</td>
</tr>
<tr>
<td>4.2 Prior literature</td>
<td></td>
</tr>
<tr>
<td>4.2.1 The context of financial instruments disclosures: From</td>
<td>132</td>
</tr>
<tr>
<td>voluntary to mandatory disclosures</td>
<td></td>
</tr>
<tr>
<td>4.2.2 The role of mandatory disclosures</td>
<td>134</td>
</tr>
<tr>
<td>4.2.3 Theoretical underpinning: The conflict between external and</td>
<td>136</td>
</tr>
<tr>
<td>internal disclosure stimuli</td>
<td></td>
</tr>
<tr>
<td>4.2.4 Financial instruments accounting standards compliance issues</td>
<td>139</td>
</tr>
<tr>
<td>4.3 Methodology</td>
<td>140</td>
</tr>
<tr>
<td>4.4 Results</td>
<td></td>
</tr>
<tr>
<td>4.4.1 Rules-based versus principles-based accounting standards</td>
<td>153</td>
</tr>
<tr>
<td>4.4.2 Balance sheet disclosures</td>
<td>159</td>
</tr>
<tr>
<td>4.4.3 Income statement and equity disclosures</td>
<td>166</td>
</tr>
<tr>
<td>4.4.4 Other aspects of accounting for financial instruments disclosures</td>
<td></td>
</tr>
<tr>
<td>4.4.4.1 Accounting policies</td>
<td>166</td>
</tr>
<tr>
<td>4.4.4.2 Hedge accounting</td>
<td>170</td>
</tr>
<tr>
<td>4.4.4.3 Fair value</td>
<td>172</td>
</tr>
<tr>
<td>4.4.5 Nature and extent of risks arising from financial instruments</td>
<td>174</td>
</tr>
<tr>
<td>disclosures</td>
<td></td>
</tr>
<tr>
<td>4.4.6 Credit, liquidity, market and other risks</td>
<td>175</td>
</tr>
<tr>
<td>4.4.7 Sensitivity analysis</td>
<td>177</td>
</tr>
<tr>
<td>4.4.8 Early adoption disclosures</td>
<td>179</td>
</tr>
<tr>
<td>4.4.9 Retracted disclosure</td>
<td>179</td>
</tr>
<tr>
<td>4.5 Conclusions, recommendations and limitations</td>
<td>180</td>
</tr>
<tr>
<td>Chapter 5: An examination of voluntary financial instruments disclosures</td>
<td>183</td>
</tr>
<tr>
<td>in excess of mandatory requirements by UK FTSE 100 non-financial firms</td>
<td>212</td>
</tr>
<tr>
<td>5.1 Introduction</td>
<td>185</td>
</tr>
<tr>
<td>5.2 Literature</td>
<td>186</td>
</tr>
<tr>
<td>5.3 Research methods</td>
<td>192</td>
</tr>
<tr>
<td>5.4 Results</td>
<td></td>
</tr>
<tr>
<td>5.4.1 AMEC’s interest rate risk management policies</td>
<td>196</td>
</tr>
<tr>
<td>5.4.2 BAT: detailed derivatives disclosures</td>
<td>201</td>
</tr>
<tr>
<td>5.4.3 Financial instruments held for trading</td>
<td>203</td>
</tr>
<tr>
<td>5.4.4 The use of (derivations of) the word hedg- amongst those who do</td>
<td></td>
</tr>
<tr>
<td>not employ hedge accounting per IAS 39 – evidence supporting legitimacy</td>
<td></td>
</tr>
<tr>
<td>theory</td>
<td>205</td>
</tr>
<tr>
<td>5.4.4.1 Kazakhmys</td>
<td>205</td>
</tr>
</tbody>
</table>
### 5.4.4.2 Liberty
5.4.4.3 Shire
5.4.4.4 Cadbury

<table>
<thead>
<tr>
<th>5.5 Conclusion</th>
<th>210</th>
</tr>
</thead>
</table>

**Chapter 6: The quantity and quality of reporting financial instruments under International Financial Reporting Standard 7**

*Financial Instruments: Disclosures* 213-268

<table>
<thead>
<tr>
<th>6.1 Introduction</th>
<th>215</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.2 Background and prior literature</td>
<td></td>
</tr>
<tr>
<td>6.2.1 Background</td>
<td>218</td>
</tr>
<tr>
<td>6.2.2 Disclosure quantity and quality</td>
<td>220</td>
</tr>
<tr>
<td>6.2.3 Theoretical underpinnings</td>
<td>224</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>6.3 Methodology</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>6.3.1 Qualitative methods: Content analysis; surveys; and semi-structured interviews</td>
<td>226</td>
</tr>
<tr>
<td>6.3.2 Hypothesis development</td>
<td>230</td>
</tr>
<tr>
<td>6.3.2.1 Information costs and visibility-independent variables</td>
<td></td>
</tr>
<tr>
<td>6.3.2.1.1 Marketability</td>
<td>231</td>
</tr>
<tr>
<td>6.3.2.1.2 Volatility</td>
<td>232</td>
</tr>
<tr>
<td>6.3.2.1.3 Dividends</td>
<td>233</td>
</tr>
<tr>
<td>6.3.2.1.4 Managerial ownership</td>
<td>233</td>
</tr>
<tr>
<td>6.3.2.1.5 Interest cover</td>
<td>234</td>
</tr>
<tr>
<td>6.3.2.1.6 News/analyst following</td>
<td>234</td>
</tr>
<tr>
<td>6.3.2.1.7 Industry: Oil &amp; gas, and mining</td>
<td>236</td>
</tr>
<tr>
<td>6.3.2.1.8 New share issue</td>
<td>236</td>
</tr>
<tr>
<td>6.3.2.2 Structure-related and performance-related variables</td>
<td></td>
</tr>
<tr>
<td>6.3.2.2.1 Size</td>
<td>237</td>
</tr>
<tr>
<td>6.3.2.2.2 Leverage</td>
<td>238</td>
</tr>
<tr>
<td>6.3.2.2.3 Market capitalisation</td>
<td>238</td>
</tr>
<tr>
<td>6.3.2.2.4 Profitability</td>
<td>238</td>
</tr>
<tr>
<td>6.3.2.2.5 Liquidity</td>
<td>239</td>
</tr>
<tr>
<td>6.3.2.2.6 Voluntary disclosures of financial instruments</td>
<td>239</td>
</tr>
<tr>
<td>6.3.2.2.7 Value of derivative assets / liabilities</td>
<td>240</td>
</tr>
</tbody>
</table>

| 6.4 Results: Stakeholder analysis of ED 7 (subsequently IFRS 7) | 242 |
| 6.5 Results: Determinants of financial instruments disclosures | |
| 6.5.1 Descriptive analysis | 253 |
| 6.5.2 Simple OLS regression results | 257 |
| 6.5.3 Multiple regression analysis | 259 |
| 6.5.4 Quantity as a proxy for quality: An extended analysis | 263 |

| 6.6 Conclusions and recommendations | 266 |

**Chapter 7: Comment integration and the relative effectiveness of constituents’ lobbying success** 269-305

| 7.1 Introduction | 273 |
| 7.2 Theoretical developments and hypothesis development | 275 |
| 7.3 | The development of Financial instruments disclosures regulation | 284 |
| 7.4 | Methodology | 285 |
| 7.5 | Findings |
| 7.5.1 Preliminary analysis | 289 |
| 7.5.2 Regression results | 297 |
| 7.6 | Conclusion | 303 |

Chapter 8: Conclusions, recommendations and limitations | 306-328 |
| 8.1 | Mandatory reporting compliance issues and a suggested rationale |
| 8.1.1 Mandatory reporting compliance issues and a suggested rationale: Conclusions | 308 |
| 8.1.2 Mandatory reporting compliance issues and a suggested rationale: Recommendations and limitations | 311 |
| 8.2 | An examination of voluntary financial instruments disclosures in excess of mandatory requirements by UK FTSE 100 non-financial firms |
| 8.2.1 An examination of voluntary financial instruments disclosures in excess of mandatory requirements by UK FTSE 100 non-financial firms: Conclusions | 312 |
| 8.2.2 An examination of voluntary financial instruments disclosures in excess of mandatory requirements by UK FTSE 100 non-financial firms: Recommendations and limitations | 314 |
| 8.3 | The quantity and quality of reporting financial instruments under International Financial Reporting Standard 7 Financial Instruments: Disclosures |
| 8.3.1 The quantity and quality of reporting financial instruments under International Financial Reporting Standard 7 Financial Instruments: Disclosures: Conclusions | 316 |
| 8.3.2 The quantity and quality of reporting financial instruments under International Financial Reporting Standard 7 Financial Instruments: Disclosures: Recommendations and limitations | 320 |
| 8.4 | Comment integration and the relative effectiveness of constituents’ lobbying success |
| 8.4.1 Comment integration and the relative effectiveness of constituents’ lobbying success: Conclusions | 322 |
| 8.4.2 Comment integration and the relative effectiveness of constituents’ lobbying success: Recommendations and limitations | 324 |
| 8.5 | Summary | 327 |

References | 329-376 |
| Appendix A Summary of key data | 377 |
| Appendix B Sample complete checklist | 407 |
| Appendix C: An overview of the application of the investigatory conceptual framework | 411 |
| Appendix D: IFRS 7 Disclosure checklist | 417 |
| Appendix E: Interview details and instruments | 438 |
| Appendix F Analysis of derivatives positions and performance for those firms who omit a reference to non-speculative behaviour | 443 |
| Appendix G: Robustness checks | 444 |
| Appendix H: The survey instrument | 447 |
| Appendix I Analysis of comments requested and amended by respondent | 449 |
| Appendix J Tests for relevance, understandability and fair representation | 482 |
## List of tables

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 1</td>
<td>Key financial data</td>
<td>10</td>
</tr>
<tr>
<td>Table 2</td>
<td>Summary motivations and contributions</td>
<td>13</td>
</tr>
<tr>
<td>Table 3</td>
<td>The main potential benefits and potential costs of informative voluntary disclosure</td>
<td>55</td>
</tr>
<tr>
<td>Table 4</td>
<td>The main disadvantages and advantages of mandating reporting requirements</td>
<td>55</td>
</tr>
<tr>
<td>Table 5</td>
<td>Analysis of derivatives by risks managed</td>
<td>127</td>
</tr>
<tr>
<td>Table 6</td>
<td>Breakdown of checklist questions between the five categories of disclosures mandated by IFRS 7</td>
<td>148</td>
</tr>
<tr>
<td>Table 7</td>
<td>Analysis of derivative financial instruments for the sample (by risk managed and type)</td>
<td>152</td>
</tr>
<tr>
<td>Table 8</td>
<td>Rules-based versus principles-based disclosure summary</td>
<td>156</td>
</tr>
<tr>
<td>Table 9</td>
<td>Balance sheet financial instruments disclosures (IFRS 7.8–7.19)</td>
<td>160</td>
</tr>
<tr>
<td>Table 10</td>
<td>Income statement and equity financial instruments disclosures (IFRS 7: 7.20)</td>
<td>166</td>
</tr>
<tr>
<td>Table 11</td>
<td>Other aspects of financial instruments disclosures (IFRS 7.21–7.30)</td>
<td>166</td>
</tr>
<tr>
<td>Table 12</td>
<td>Nature and extent of risks arising from financial instruments (IFRS 7.31–7.42)</td>
<td>175</td>
</tr>
<tr>
<td>Table 13</td>
<td>Early adoption disclosures (IFRS 7: 7.43–7.44)</td>
<td>179</td>
</tr>
<tr>
<td>Table 14</td>
<td>Breakdown of checklist questions between the five categories of disclosures mandated by IFRS 7</td>
<td>198</td>
</tr>
<tr>
<td>Table 15</td>
<td>Explanatory variables and measurement</td>
<td>241</td>
</tr>
<tr>
<td>Table 16a</td>
<td>Comment letters summary</td>
<td>246</td>
</tr>
<tr>
<td>Table 16b</td>
<td>Analysis of respondent attitudes towards adoption of ED 7</td>
<td>247</td>
</tr>
<tr>
<td>Table 17</td>
<td>Survey summary</td>
<td>251</td>
</tr>
<tr>
<td>Table 18</td>
<td>Dependent variable: Quantity and quality</td>
<td>254</td>
</tr>
<tr>
<td>Table 19</td>
<td>Descriptive statistics for independent variables</td>
<td>255</td>
</tr>
<tr>
<td>Table 20</td>
<td>OLS simple regression</td>
<td>258</td>
</tr>
<tr>
<td>Table 21</td>
<td>Pearson cross-correlations between variables</td>
<td>261</td>
</tr>
<tr>
<td>Table 22</td>
<td>Regression results</td>
<td>262</td>
</tr>
<tr>
<td>Table 23</td>
<td>Direction of independent variables (t-stats indicating significance where appropriate; correlation graphs)</td>
<td>264</td>
</tr>
<tr>
<td>Table 24</td>
<td>Analysis of accepted proposed amendments (grouped) by paragraph and by group</td>
<td>280</td>
</tr>
<tr>
<td>Table 25</td>
<td>Amended proposals related to grammatical issues</td>
<td>282</td>
</tr>
<tr>
<td>Table 26</td>
<td>Ranked responses</td>
<td>287</td>
</tr>
<tr>
<td>Table 27</td>
<td>Classification of comments: Analysis of arguments</td>
<td>288</td>
</tr>
<tr>
<td>Table 28</td>
<td>Summary of respondent attitudes</td>
<td>291</td>
</tr>
<tr>
<td>Table 29</td>
<td>Analysis of changes requested and their relative success</td>
<td>295</td>
</tr>
<tr>
<td>Table 30</td>
<td>Descriptive statistics</td>
<td>296</td>
</tr>
<tr>
<td>Table 31</td>
<td>Correlation coefficients between variables</td>
<td>302</td>
</tr>
<tr>
<td>Table 32</td>
<td>Regression results</td>
<td>303</td>
</tr>
</tbody>
</table>
List of figures

| Figure 1: Determinants of disclosure compliance | 137 |
Acknowledgements

First and foremost I would like to thank my supervisor, Professor Kevin McMeeking, for the time, dedication, advice and encouragement he has devoted to me throughout this process. As this chapter closes, I look forward to a future of friendship and research collaborations.

I would also like to thank friends and colleagues at University of Exeter, University of Bristol and University of Wales, Newport. There are those who have offered important criticisms and comments throughout and, just as importantly, shown me constant support. These people know who they are but of special note I’d like to mention Prof. Mike Jones, Prof. Sheila Ellwood, Prof. Daniella Acker, Prof. David Ashton, Dr. Nikola Petrovic, Dr. Piotr Korczak, Dr. Paula Hill, Jared Davies, Dr. Simon Parry and Prof. Richard Jackson.

Many thanks to the editors – Prof. Elaine Harris, Prof. Richard Slack and Philip Shrives – and two blind reviewers at JAAR for their comments and suggestions in relation to Chapter 5. Thanks also to the editor – Prof Lee Parker – and three blind reviewers at AAAJ for their thoughts for improvements in relation to Chapter 4. These reviews have greatly enhanced the quality of the content of this thesis.

There have been many others who have offered help and guidance. My gratitude to all the participants at the following conferences, presentations and seminars for their comments and suggestions: European Accounting Association Conference (2010); European Risk Research Conference (2010); Financial Reporting and Business Communication Conference (2009 and 2010); British Accounting Association Conference (2009); University of Stirling (2010); IESEG (2011); University of Bristol (2008 and 2009); and University of Exeter (2008, 2009 and 2010).

Last but certainly not least, my warmest thanks to family and friends. I know that I have bored you with this project. The bad news is that I cannot make any promises that I won’t bore you in the future with something else.
Author's declaration

I declare that the work in this dissertation was carried out in accordance with the Regulations of the University of Exeter. The work is original and no part of the dissertation has been submitted for any other academic award. Any views expressed in the dissertation are those of the author.

Chapter 5: ‘An examination of voluntary financial instruments disclosures in excess of mandatory requirements by UK FTSE 100 non-financial firms’ has been published in the Journal of Applied Accounting Research, Vol. 11, No. 2, pp. 133–153. The paper appears here in full and with only minor amendments. Professor McMeeking is a named co-author as he has been my supervisor through my studies and I am thankful to him for his guidance through the publication process. His role in the project was largely supervisory and I am grateful for his advice and comments throughout. The data collected and the analysis performed was almost exclusively my own work. The paper was double-blind peer reviewed and I am grateful for the comments raised by these individuals and by the editors.

Chapter 4: ‘Mandatory reporting compliance issues and a suggested Rationale’ has been submitted as a co-authored paper with Professor McMeeking to Accounting, Auditing and Accountability Journal. The paper has been reviewed by three anonymous referees. Again, I am grateful for both the reviewers’ comments and the part Professor McMeeking has played relating to this project. Again, his role has been almost exclusively supervisory with the exception of acting as a second coder to establish the reliability of the compliance checklist results, and providing helpful comments and suggestions throughout.

SIGNED: ......................................... DATE:..........................
Chapter 1: Introduction

The objective of this chapter is to outline the development, importance, scope and scale of financial instruments reporting, whilst also developing the basis for a critical examination of the potential benefits, costs and purposes of the related disclosures. This chapter sets out the research questions alongside the concepts and concerns that are further elaborated upon during the remainder of this thesis. This discussion also establishes the contribution of this study to the field. In addition, this chapter communicates the nature of the project and a brief guide to the disclosure requirements related to financial instruments as well as serving as an introduction to the sample and research methods adopted.

1.1 The importance of reporting financial instruments and their associated risks

1.1.1 Financial instruments: Definitions

A financial instrument is defined as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Most commonly, people associate financial instruments solely with derivative financial instruments; however, a financial asset also takes many other forms – for example, cash, equity instruments, contractual rights to receive cash or another financial instrument and so forth. An example of a financial liability on the other hand might be a contractual obligation to deliver cash or another financial asset to another entity or a contract that will or may be settled in the entity’s own equity instruments. An equity instrument “is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities” (IAS 32.11).

International Accounting Standard 39 Financial Instruments: Recognition and Measurement (IAS 39) deals separately with four types of financial asset and two types of financial liability. The classifications are as follows: financial assets and

---

1 This is subject to change as International Financial Reporting Standard 9 Financial Instruments (IFRS 9) is set to replace IAS 39 in its entirety (and offers an early acceptance clause starting for 2009 year end financial statements). IFRS 9 divides all financial assets that are currently in the scope of IAS 39 into two classifications – those measured at amortised cost and those measured at fair value.
financial liabilities at fair value through profit or loss; loans and receivables; held-to-maturity investments; available for sale financial assets; and other financial liabilities. The initial recognition, subsequent measurement and recognition in the Statement of Comprehensive Income varies according to the nature and type of instrument. Further definitions of these classes of financial asset and liability alongside other relevant descriptions follow.

A financial liability at fair value through profit or loss is a financial liability that meets either of the following conditions: 1) it meets the definition of held for trading; 2) upon initial recognition\(^2\) it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph IAS39.11a, or when doing so results in more relevant information.\(^3\) A financial asset or financial liability is held for trading if (IAS 39.9): it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or it is a derivative (except for a derivative that is a financial guarantee contract\(^4\) or a designated and effective hedging instrument).

Held-to-maturity investments are financial instruments with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (other than those which the entity has already elected to be fair value through profit or loss or available for sale or that meet the definition of loans and receivables) (IAS 39.9). Loans and receivables are defined as non-derivative

\(^2\) The definition of initial recognition and measurement are: the amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

\(^3\) This might be because either: 1) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or 2) a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 Related Party Disclosures), for example the entity’s board of directors and chief executive officer.

\(^4\) A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
financial assets with fixed or determinable payments that are not quoted in an active market other than those the entity intends to sell immediately or in the short term and those which the entity initially designates as fair value through profit or loss or available-for-sale (IAS 39.9). Available-for-sale financial assets are those non-derivatives which are not designated as fair value through profit or loss, are not classified as loans and receivables or held-to-maturity investments, and are not held for trading.

Another related and important definition is of a derivative. A derivative is described as a financial instrument or other contract with all three of the following characteristics [IAS 39.2-7]: 1) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’); 2) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and 3) it is settled at a future date.

IFRS 7 commonly refers to the disclosure of fair value (most notably through IFRS 7.25-30) and IAS 39 requires that financial assets and liabilities are measured initially at fair value. As this approach is central to that of the standard as a whole then a definition is provided. Fair value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction (IAS 39.9). The application guidance (IAS39.AG64) states that for initial recognition purposes, the transaction price is normally the most appropriate value to record the asset or liability given it is the best evidence available. Occasionally financial assets (and liabilities) need to be derecognised. IFRS 7.12 requires disclosure of this derecognition which is defined as the removal of a previously recognised financial asset or financial liability from an entity’s statement of financial position. This occurs when either the contractual rights to the
asset’s cash flows expire or the asset is transferred and the transfer qualifies for derecognition.5

Hedge accounting, the recognition of assets, liabilities, gains and losses as well as the associated IFRS 7 requirements are discussed in more detail at the end of this chapter. However, there are several definitions contained within IAS 39 which are given below. The financial instruments standards argue that hedge accounting will typically take one of three forms: cash flow hedge; fair value hedge; or the hedge of a net investment in a foreign operation. These are defined as follows:

- **Cash flow hedge**: where the hedge reduces the risk of variability in cash flows associated with a future transaction. This is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probably forecast transaction. This exposure could affect profit or loss (IAS 39.86b).
- **Fair value hedge**: where the hedge offsets the risk of volatility in the fair value of a recognised asset or liability or an unrecognised firm commitment or an identified portion of such an asset, liability or firm commitment that is attributable to a particular risk and could affect profit or loss (IAS 39. 86a); or
- **Hedge of the net investment in a foreign operation**: where there is a hedge of the foreign exchange currency exposure to changes in the reporting entity’s share in the net assets of that foreign operation (IAS 39.102).

International Financial Reporting Standard 7 *Financial Instruments: Disclosures* (IFRS 7) is the primary concern of this study. This study has examined the disclosures of financial instruments and the adopted disclosure practices and strategies in relation to the FTSE 100 non-financial IFRS 7 compliant companies for the first period of adoption – i.e. years commencing on or after 1 January 2007. The issues of presentation, measurement and recognition have been left for other researchers to investigate in more detail. However, I believe this study will enhance the contribution of their work as well as providing a contribution specifically to the disclosure literature in its own right.

---

5 The qualification decision rests on a combination of risk and rewards and control tests (see the derecognition decision tree at IAS 39.AG36)
1.1.2 Financial instruments: Use, misuse, abuse and disclosure

Users of financial information from across the academic and professional communities have called upon the accounting standard setters to ensure greater comparability and transparency in relation to the reporting of the usage and management of financial instruments, and in particular derivative financial instruments (for example Mears, 2009 [ACCA]; Sleigh-Johnson, 2009 [ICAEW]; Barth and Schipper, 2008; Cox, 2008 [Chairman of the SEC]; Bhamornsiri and Schroeder, 2004; Fitch Ratings Research, 2004; Woods and Marginson, 2004). This has resulted from a general scepticism amongst certain groups about whether these instruments are being used by firms for traditional risk management purposes or whether they are being misused or abused. Research has suggested that investors imagine firms are carrying large losses in their Statements of Financial Position (Balance Sheets) because it is difficult to ascertain if a firm has entered into speculative positions based upon the disclosed information (for example Sapra and Shin, 2004). Though intuitively one would expect mandated reporting requirements to improve this position, there are those who believe that this problem is sometimes caused, and often exacerbated by, overly complex accounting standards which have impaired the core qualitative characteristics of financial reporting (Woods and Marginson, 2004; Hernandez Hernandez, 2003).

A recent review by the Financial Reporting Council (FRC) (2009) was introduced as follows (p.2): “Concerns about the increasing complexity and decreasing relevance of corporate reports have been growing in recent years. Many people point to the increasing length and detail of annual reports – and the regulations that govern them – as evidence that we have a problem. Others are more worried that reports no longer reflect the reality of the underlying businesses, with key messages lost in the clutter of lengthy disclosures and regulatory jargon”. The report argued that a principles dominated system would benefit all members of the financial reporting community. After this, two further related reports have emerged. One of these was a follow-up from the original wherein the FRC made calls for the ‘de-cluttering’ of annual reports (2011) and outlined a three-pronged strategy to dealing with the
issue. The other report was published by the Institute of Chartered Accountants in Scotland and the New Zealand Institute of Chartered Accountants (2011) and addressed the question of whether disclosure could be stripped back to that which was important based upon a system principally of materiality (alongside other factors such as eliminating duplication). The authors found that a reduction of approximately 30% of disclosures could be expected if their proposed system was adopted. These issues are currently under debate but this insight into the current state of the ongoing debate serves to highlight the importance and timeliness of this study and others of this type.

There are several reasons why there have been calls for greater transparency in relation to derivatives reporting particularly, but also to financial instruments and the risks associated with their usage and management more generally. Until the mid-1990s there was virtually no effective guidance available dealing with accounting for financial instruments, regardless of whether that was in relation to their presentation, recognition, measurement or disclosure. Companies were therefore free to disclose as little or as much as they wished, and in practice used a wide range of disclosure methods and strategies. Moreover, most companies recorded derivatives at historical cost, which often does not convey a true and fair picture of the risks and rewards faced. As a result, the financial statements of a company could be rendered meaningless by the non-disclosure of a financial instrument that could have a material impact on the Statement of Financial Position (Balance Sheet) or Statement of Consolidated Income (Income Statement), in some cases turning profits into losses and net asset positions into net liability positions.

The world’s attention was captured by the role that complex financial instruments and positions played in the collapse of Barings in the United Kingdom (UK; 1995)

---

6 These approaches are based around these themes: 1. Calling for continued action against barriers; 2. Addressing (disclosure) behaviours; 3. Providing disclosure aids to preparers.

7 Both FRC reports (2009 and 2011) highlighted criticisms of the complexity of financial instruments disclosures but did not propose a way of addressing the issue and instead proposed this as one among many areas to be addressed at a later date. It is worth noting that the 2009 report appears to be defending the financial instruments disclosures as required by IFRS 7. The report reads under a section sub-titled ‘unintended consequences’ dealing specifically with IFRS 7 (p.20): “Part of the issue here is that the minimum disclosure requirements focus on specific instruments rather than the bigger picture, so meeting these requirements does not provide a good understanding of the risk management strategies used by management. This is interesting, because the standard is actually underpinned by the principle that information should be provided ‘through the eyes of management’.”
and Long-Term Capital Management in the United States (US; 1998). At this point more than any other in the past, there was a general acknowledgement that greater transparency was required urgently. It was considered that full disclosure of financial instruments-based risk management strategies might have prevented, or at least alerted, the world’s markets to the potential problems and levels of risk exposure. The controversy caused by financial instruments-based strategies continues to vex standard-setters in relation to appropriate treatment, presentation and disclosure. This is a complex and evolving issue that has not been possible to adequately resolve, and many examples can be found of patchwork solutions to immediate problems; for example, the EC has recently adopted new regulations related to short selling of financial instruments.9

The release of Exposure Draft 7 (ED 7) in July 2004, which after modifications became IFRS 7 in August 2005, signalled a conclusion (however temporary) to the long and complex project undertaken by the standard-setters and the wider stakeholder community to ensure financial instruments disclosures provided users with the information they required. The International Accounting Standards Board (IASB) have assured stakeholders on several occasions during the recent discussions concerning financial instruments presentation, measurement and recognition, that they feel that IFRS 7 is fit for purpose and will only be amended on an ad hoc basis, rather than being revised in its entirety. Therefore, the development of IFRS 7 and its subsequent adoption affords researchers a unique opportunity to explore complex auditing issues and financial reporting disclosures from many angles.

It would seem an unfortunate but necessary conclusion that any financial reporting solutions are viewed as only ever, at best, interim – hence the rapid change in reporting requirements. The accounting standard-setters face an uphill task in trying to maintain pace with the growth of financial instruments’ usage and complexity. The Bank for International Settlements triennial review of foreign exchange traded

---

8 Crisis in 1998; fund closed in 2000.
derivatives (2007) showed that the average daily turnover was at $3.2 trillion in April 2007.\textsuperscript{10} In comparison with April 2004, this represented an increase of 63% at constant exchange rates. Other studies of derivative financial instruments usage show similar patterns. However, the most recent banking crisis and the role of derivatives in this event (especially credit default swaps), has shown that complexity can obfuscate understanding even under a relatively robust reporting regime.

1.1.3 The sample for this study: An introduction and key data

The increase in usage has been mirrored by a similar growth in the quantity of information being disclosed about financial instruments in the annual report. To substantiate the claim that disclosure volume has changed, it is worth noting that on average there has been a 40% increase in the volume of financial instruments disclosures as compared to the period immediately prior to the adoption of IFRS 7,\textsuperscript{11} based upon the sample selected for this project. For financial years commencing on or after 1 January 2007, the quantity of disclosure attributed to financial instruments is high – averaging 3.9% of the total word count contained within the annual report, 4.0% of the total number of pages that comprise the annual report and 8.9% of the lines of those that appear in the annual report as a whole. Even the company with the least amount of words attributable to financial instruments disclosures still devoted 1% of the overall word count, whilst the company with the most afforded 8.2% to this area. Financial instruments disclosures are thus a significant amount of the total financial reporting disclosures, at least for this sample of companies.

Though this project is a mixed methods study, combining survey data, interview data, comment letters and market information, the primary source of information was the annual report. The sample chosen for this study were the FTSE 100 non-financial IFRS 7 compliant companies as at 13 October 2008.\textsuperscript{12} It is most common for studies of financial instruments to either focus on financial firms or non-financial

\textsuperscript{10} The 2007 survey figures are shown here because the date for the adoption of IFRS 7 was 1 January 2007. The 2010 comparative survey showed that global foreign exchange market turnover was 20% higher in April 2010 than in April 2007, with an average daily turnover of $4.0 trillion.\textsuperscript{11} In other words, years commencing on or after 1 January 2006.\textsuperscript{12} Amendment to IFRS 7 for disclosures relating to reclassifications of financial assets – effective date 1 July 2008 but released in October 2008.
firms. This distinction exists because financial firms, by and large, make greater use of financial instruments, and this usage is often underpinned by more complex strategies such as speculation, portfolio hedging and embedded derivatives. Therefore a separate regulatory environment has developed to match the different risks and core strategies relevant to these firms. Thus, there is a significant

13 DeCeuster et al. (2002) argued that there is little evidence related to non-financial firms’ derivatives programmes and therefore this in itself justified this as an area worthy of separate attention and study. 14 In the UK separate requirements and regulations for financial institutions are currently developed, monitored and overseen principally by the FSA. It is worth noting that on 16 June 2010 it was announced by the current parliament that the FSA would be abolished and its responsibilities would be divided between a number of new agencies and the Bank of England. Of special note is the creation of the Financial Conduct Authority who will be responsible for policing the banking system and a Prudential Regulatory Authority who will carry out the prudential regulation of financial firms of all types. The Bank of England will subsume many responsibilities but it will also establish a Financial Policy Committee. These changes are set to be in place by 2012. As an example of a specific requirement included within the FSA regulations are certain rules governing exposures related to derivatives, repurchase agreements, reverse repurchase agreements, stock borrowing and loan transactions that require calculations using the FSA approved models and thus these attract separate explanatory disclosures. In addition, the stress testing and sensitivity analysis disclosures are more tightly regulated for financial institutions (and require approval from the FSA and are subsequently graded) and thus again promote more disclosures. Currently UK listed financial firms only need apply UK banking regulations thus avoiding the complexities of the US banking regulatory systems including detailed disclosures to bring the reports in line with acts such as Sarbanes Oxley. However, cross-listed firms will need to meet the overseas market’s listing rules which, for example in the US, means adherence to SEC, US Fed rules and regulations alongside relevant laws (including for example: International Banking Act of 1978, the Bank Holding Company Act of 1956, as amended (BHC Act), the Foreign Bank Supervision Enhancement Act of 1991, the Financial Services Modernization Act of 1999 and the USA PATRIOT Act of 2001). Many of these rules, regulations and laws trigger certain specific disclosures in the annual report. In addition, financial institutions will meet the requirements of other bodies including the Basel Committee of Banking Supervisors (BCBS), International Organisation of Securities Commissions plus the annual reports also reflect requirements derived from EU directives. The BCBS have developed a proposed regulatory framework (Basel III) and best practice guidance. “Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to: improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance;” and, importantly when addressing the specific question of the comparability between financial and non-financial firms, to “strengthen banks’ transparency and disclosures” (www.bis.org). Basel III contains many sections on disclosure requirements of which the most prominent are the Pillar 3 market discipline disclosures. Alongside and within these market discipline disclosures are requirements relating specifically to market, credit and liquidity risks (e.g. a new leverage metric; enhanced disclosures related to components of regulatory capital; a comprehensive explanation of how a bank calculates its regulatory capital ratios; the Liquidity Coverage Ratio and a longer term liquidity metric - the Net Stable Funding Ratio). There are also other stakeholders in the regulatory framework and for financial institutions these can be political. In terms of European influence, the EU (with the European Banking Authority working on their behalf) have the power to mediate between and override national authorities under certain circumstances. On a global level the G20 and the Financial Stability Board are also
increase in the associated intricacy of disclosures and the regulatory requirements placed on them. This study focuses exclusively on non-financials.

In total 66 companies’ financial instruments disclosures were comprehensively reviewed. Of the FTSE 100, 12 companies had not yet adopted IFRS 7 for the first time due to the timing of their year-ends, and the remaining 22 were financial companies. These reports were reviewed for compliance levels, quantity and other presentational and rhetorical strategies. Only the key findings are reported within this study, and they are centred around the questions shown in Section 1.2 below. Table 1 summarises some key financial data about the entities sampled and their financial instruments positions to enable an understanding of the size and scope of financial instruments usage.\textsuperscript{15} For a fuller analysis of the information related to the sample see appendix A.

**Table 1: Key financial data**

<table>
<thead>
<tr>
<th></th>
<th>Max</th>
<th>Min</th>
<th>Mean</th>
<th>St'd dev'n</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets (£mill)</td>
<td>135,801.0</td>
<td>1,185.0</td>
<td>16,077.1</td>
<td>26,447.3</td>
</tr>
<tr>
<td>Gearing (%)</td>
<td>17.9</td>
<td>(6.8)</td>
<td>1.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Net profitability (%)</td>
<td>0.8</td>
<td>(0.1)</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Liquidity (CAs:CLs)</td>
<td>7.9</td>
<td>0.2</td>
<td>1.3</td>
<td>1.3</td>
</tr>
<tr>
<td>Derivative assets (CY) (£ mill)</td>
<td>20,005.0</td>
<td>-</td>
<td>702.0</td>
<td>2,734.0</td>
</tr>
<tr>
<td>Derivative assets (PY) (£ mill)</td>
<td>20,264.0</td>
<td>-</td>
<td>645.2</td>
<td>2,956.9</td>
</tr>
<tr>
<td>Derivative liabilities (CY) (£ mill)</td>
<td>20,637.0</td>
<td>-</td>
<td>698.4</td>
<td>2,870.8</td>
</tr>
<tr>
<td>Derivative liabilities (PY) (£ mill)</td>
<td>20,381.0</td>
<td>-</td>
<td>820.3</td>
<td>3,184.6</td>
</tr>
<tr>
<td>Cash flow hedge gains/ (losses) to equity (CY) (£ mill)</td>
<td>446.0</td>
<td>(424.0)</td>
<td>(16.7)</td>
<td>114.6</td>
</tr>
<tr>
<td>Cash flow hedge gains/ (losses) to equity (PY) (£ mill)</td>
<td>413.0</td>
<td>(645.0)</td>
<td>(16.3)</td>
<td>150.4</td>
</tr>
<tr>
<td>Net Fair value hedge gains / (losses) (CY) (£ mill)</td>
<td>68.2</td>
<td>(219.0)</td>
<td>(5.6)</td>
<td>43.4</td>
</tr>
<tr>
<td>Net Fair value hedge gains / (losses) (PY) (£ mill)</td>
<td>72.0</td>
<td>(26.0)</td>
<td>2.9</td>
<td>13.1</td>
</tr>
<tr>
<td>Fair value derivative gains / (losses) (CY) (£ mill)</td>
<td>3,254.0</td>
<td>(181.0)</td>
<td>55.4</td>
<td>401.9</td>
</tr>
<tr>
<td>Fair value derivative gains / (losses) (PY) (£ mill)</td>
<td>9,694.0</td>
<td>(608.0)</td>
<td>154.9</td>
<td>1,198.2</td>
</tr>
</tbody>
</table>

working with the financial firms regulators to develop a coherent worldwide regulatory framework. By way of example of the complexity that this has brought to the disclosures in the annual report for financial firms, in the case of Barclays Bank plc for the year ended 31 December 2010, there were 82 pages specifically dedicated to derivative financial instruments and the associated risks and management of those risks. This compares to a maximum of 12.5 pages for the non-financial firms covered by this sample and an average (for this study’s sample) of just over 5 pages.\textsuperscript{16} Note: This table emphasises derivatives positions – however, this project covers all financial instruments.
<table>
<thead>
<tr>
<th>Audited by</th>
<th># of entities</th>
<th>% coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deloitte</td>
<td>15</td>
<td>22.7%</td>
</tr>
<tr>
<td>E&amp;Y</td>
<td>11</td>
<td>16.7%</td>
</tr>
<tr>
<td>KPMG</td>
<td>13</td>
<td>19.7%</td>
</tr>
<tr>
<td>PwC</td>
<td>27</td>
<td>40.9%</td>
</tr>
<tr>
<td>Others</td>
<td>0</td>
<td>0.0%</td>
</tr>
<tr>
<td>Total</td>
<td>66</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Note: CY = current year; PY = prior year.

1.1.4 Research questions

DeMarzo and Duffie (1995) found that certain risk-reducing information, such as disclosure of hedging strategies, was more important than other forms and that managerial disclosure strategies would change dependent upon incentives – and that this may create internal conflict.\(^{16}\) Though this project does not aim to test whether firms undertake optimal hedging strategies, the work of DeMarzo and Duffie and their successors related to disclosure strategies have opened the door to some interesting questions. Two recent papers by Beyer et al. (2010) and Leuz and Wysocki (2008) have contributed significantly to the debate by thoroughly reviewing the extant literature in the field of disclosure, financial reporting and disclosure regulation. Though the conclusions are mixed about the benefits of mandating disclosure both reviews have carefully identified a number of areas for further research and both believe that the literature lacks a workable and coherent framework for measuring the quality of financial reporting and disclosure regulation. Recent work\(^{17}\) has striven to address the question of quality of corporate reporting as this might permit a greater understanding of the potential benefits of disclosures generally, but also help to address the subject of mandating disclosures. The issues which are considered for special attention during this project are (see Table 2 for analysis of motivations and contributions):

---

\(^{16}\) Specifically related to optimal hedging policies and strategies.

\(^{17}\) See chapter 2; specifically sections 2.2.4 (for a review of the literature) and 2.6 (for a review of the theory)
1. Whether firms comply with the mandatory reporting requirements and the possible rationale behind any non-, partial or full compliance;

2. Whether firms provide information in excess of the disclosure requirements and, if so, why;

3. Whether one can measure the quality of the disclosed information and the significance of this measure to disclosure research more generally; and

4. Whether relative power exists amongst lobbyists in affecting the proposals related to the final requirements of the financial instruments disclosures accounting standard.

Therefore, in the light of the release of IFRS 7, the increased information requirements, the growing importance of financial risk disclosures, and the increased attention on the use of financial instruments (particularly derivatives), this project seeks to address a significant gap in the existing literature.
Table 2: Summary motivations and contributions

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Motivation(s)</th>
<th>Contribution(s)</th>
</tr>
</thead>
</table>
| 4: Mandatory reporting compliance issues and a suggested Rationale | • A first full review of FTSE 100 non-financial firms’ adoption of IFRS 7.  
• A theoretical exploration of the rationale for full, partial or non-disclosure of mandatory financial instruments reporting requirements. | • First study to show high compliance levels with IFRS 7 reporting requirements.  
• First UK-based study of financial instruments disclosures.  
• Developing a conceptual framework as a means to explore the theoretical rationale behind compliance and non-compliance. |
| 5. An examination of voluntary financial instruments disclosures in excess of mandatory requirements by UK FTSE 100 non-financial firms | • To investigate whether firms provide more information than IFRS 7 requires.  
• To identify possible causes for this variation and attempt to establish links to relevant disclosure theory. | • This chapter provides a methodological contribution as it is the first of its kind to explore over-compliance using content analysis and a checklist.  
• First study to find clear evidence of over-compliance and analyse on a case-by-case basis whether this is supported by relevant disclosure theory, specifically legitimacy theory. |
| 6. The quantity and quality of reporting financial instruments under International Financial Reporting Standard 7 Financial Instruments: Disclosures. | • This chapter asks whether studying mandatory disclosures for quality and quantity is worthwhile. Alongside this, the study asks:  
  o Can the quantity of disclosures be measured?; and  
  o Can the quality of disclosures be measured?  
  • To verify ex-ante and ex-post the quality of IFRS 7’s reporting requirements to key user groups.  
  • To investigate the determinants of financial instruments disclosures.  
  • To explore whether quantity is an appropriate proxy for quality when looking at financial instruments disclosures.  | • This study adopts compliance as a measure of quality and word count as a measure of quantity.  
• Finds that different measures of quantity have an insignificant impact on the results.  
• Finds that, in this context, quantity is not an appropriate proxy for quality. |
| 7. Comment integration and the relative effectiveness of constituents’ lobbying success. | • An investigation of previously developed lobbying theories: namely regulatory capture theory and the political economy of accounting.  
• To investigate whether there is relative power amongst coalitions, groups and alignments.  
• To investigate whether discourse strategies play a significant role in relative success of comments.  
• For the first time, to investigate whether geographical origin of the constituent is a significant determinant of comment success. | • Finds no evidence of either regulatory capture or political economy of accounting.  
• Finds that amendments proposed which arise from the UK and zones outside of Europe and the US are significantly less likely to be adopted into the final standard. |
1.2 The purposes of disclosure

This project focuses exclusively on IFRS 7, which is a disclosure only standard. Therefore, it is appropriate to briefly outline the theoretical purposes of disclosure and in particular, the purpose of high quality disclosure. There are arguments in favour of producing high quality disclosures for both auditors and preparers of financial statements. First, the case of auditors is considered and then the study moves on in turn to reflect on relevant issues for preparers.

1.2.1 Auditors and high levels of disclosure

One could presume that a significant component of audit quality can be assessed by measuring levels of client(s) compliance with the relevant standard or set of standards. The higher the actual or perceived audit quality, the greater the opportunities to charge higher fees, gain greater market share, attract better staff and so forth (Craswell et al., 1995; DeAngelo, 1981). In addition, due to the potential litigation costs and reputational damage for auditors of failing to report non-compliance with disclosure requirements, one is forced to ask why there is any non-compliance with the relevant regulations or requirements.

In the context of this study this argument becomes especially valid as the entire sample were audited by the accounting firms commonly perceived to be the elite (Dunn and Mayhew, 2004; Francis, 2004), i.e. the Big Four: PricewaterhouseCoopers (PwC); Deloitte; KPMG; and Ernst & Young (E&Y) [hereafter referred to as the ‘Big Four’]. Both audit researchers and professional commentators have long held that the auditing profession has a top tier\(^{18}\) who can charge a premium for their work because of the associated audit quality and the reputational capital held (Craswell et al., 1995; McMeeking et al., 2006; Francis and Wang, 2008). The greater assurance from Big Four work and the associated fee premium is usually attributed to

\(^{18}\) Obviously in this case the Big Four although this sometimes in accounting and audit research becomes the Big Four, Five or Six (dependent upon the date of the study) + 2
either greater effort (more hours billed) and/or greater expertise (higher charge-out rates). The determinants of disclosures studies tend to support this argument and thus this implies that smaller audit firms will probably have lower audit quality levels and higher non-compliance issues. Therefore, as all companies in the sample selected for this project are audited by one of the Big Four, then – and to the extent that one accepts prima facie that the Big Four undertake the highest quality audits – one can assume that the compliance of companies in this study will be the highest across the total population of companies reporting under IFRS 7.¹⁹

1.2.2 Preparers and high levels of disclosure

There is a vast literature related to the purposes of firm-level information disclosure and annual report disclosure in particular (see reviews by Healy and Palepu, 2001; Verrecchia, 2001; Botosan, 2006; Leuz and Wysocki, 2008; Beyer et al., 2010). However, as stated by Beretta and Bozzolan (2004: 268), “risk disclosure is just becoming a serious topic for research” and there remains only a limited amount of work concerned with financial instruments disclosures in the annual report.

It is a common misconception that an unqualified audit report is a signal of full compliance with mandated disclosure requirements. When companies do not comply with disclosure requirements it is necessary to ask why this might be

---

¹⁹ It is worth noting that survey results and interviewees comments indicated that this statement holds. The survey contained three questions on this subject: 1) The Big Four audit firms have the knowledge, technical expertise and resources to review and/or produce the disclosure required by IFRS 7; 2) Mid-tier audit firms (i.e. firms with 20 partners or more excluding the Big Four) have the knowledge, technical expertise and resources to review and/or produce the disclosure required by IFRS 7; and 3) Audit firms outside of the Big Four and mid-tier firms have the knowledge, technical expertise and resources to review and/or produce the disclosure required by IFRS 7. The results indicated an incrementally declining level of support for these three tiers with the Big Four scoring 3.76 (out of 5); the mid-tier scoring 3.10; and smaller firms scoring 2.50. However, one analyst remarked that there were smaller firms with specialism in this area and these firms had the potential to outperform others. Two interviewees thought that the auditors, regardless of their status or specialism, would struggle to adequately audit these disclosures to the same extent as less complex areas of the financial statements. All other respondents who offered an opinion thought that the whole area of financial instruments reporting for multinationals that employed complex financial instruments-based risk management strategies could only be audited in an appropriate manner by the Big Four.
the case. Thus, this discussion moves into a consideration of the disclosure strategies for preparers.

Prior work tells us that corporate disclosure practices are motivated on the one hand by internally driven corporate communication objectives and on the other by external pressures and stimuli. Beyer et al. (2010) have conducted a thorough review of literature investigating the financial reporting environment and agree with this conclusion. They have stated (p.2) that the “two reasons for information environments to develop endogenously: the information asymmetry between capital providers and entrepreneurs with investment opportunities (the valuation problem) and the agency problems that result from the separation of ownership and control (the stewardship problem)”.

Leuz and Wysocki (2008) broadly have the same opinion as they agree with Verrecchia’s (2001) proposals that disclosure can help ease the adverse selection problem whilst at the same time levelling the field for investors by increasing liquidity, minimising information asymmetry costs and reducing uncertainty about firm value.

It is the fiduciary obligation of managers to initially focus on providing useful decision-making information to external users, in particular the owners of the business. However, there are opportunities and constraints that might affect the nature and content of the information that is chosen to be disclosed. From an internal perspective, there are many possible advantages to making voluntary disclosures; however, it has been shown that in particular the gains are principally associated with reputational capital improvements (Bebbington et al., 2008; Polonsky and Jevons, 2006), the link to reduced agency and political costs (Jensen and Meckling, 1976), and the positive contribution to the pressures exerted from the labour market (Fama, 1980; Kuruppu and Milne, 2010). Ultimately these arguments conclude in cost of capital advantages (Botosan, 1997, 2006; Ross, 1979).

Recent studies have found that these benefits are maximised when the disclosure is of a particularly high calibre (Abraham and Cox, 2007; Armitage and Marston, 2008). In the same context, several studies (e.g. Jorgensen and
Kirschenheiter, 2003; Hughes Liu and Liu, 2007; and Lambert, Leuz and Verrecchia, 2007a; 2007b) have recently re-examined the level of estimation risk and the relationship with an entity’s cost of capital. They have shown that the level of estimation risk (based on the covariances of a firm’s cash flows with cash flows from other firms) decreases as the quality of firm-specific disclosures increases.

It is possible to summarise the external motivations into two major sub-categories. They are intended: first, to provide useful information for investors and other stakeholders, e.g. to reduce information asymmetry for signalling purposes (Akerlof, 1970); and second, to meet minimum disclosure requirements to ensure clean audit reports (e.g. Healy and Palepu, 2001; Easterbrook and Fischel, 1984). Due to the mandatory nature of financial instruments disclosures and the associated assumption that the requisite information must be disclosed, the internal motivation becomes to ensure that the disclosures being made either add value or minimise losses, whether these be of a financial or non-financial nature.

Agency theory studies have found that higher levels of transparency increase firm value by exposing managerial decision making to users (for example, Doidge, Karolyi and Stulz, 2004). The argument put forward is that managers make better decisions because of the reduced opportunities to appropriate for themselves (e.g. Shleifer and Wolfenzon, 2002; Chi, Liu and Wang, 2009). In addition, Lambert et al. (2007a) showed that where this effect can be proven then there is a corresponding reduction in the cost of capital.

Beyer et al. (2010) have argued that when firms do not disclose private information voluntarily there is a role for standard setters to mandate these disclosures. When the standard setters elect to mandate disclosures this should eliminate the arguments of the voluntary disclosure research related to whether entities elect to make the disclosure or not dependent upon an ex-ante interpretation of the potential effects of the good news and bad news disclosures. However, this study and others in the same field – financial instruments (for example Lopes and Rodrigues, 2007; Hassan et al., 2008) –
have found that full disclosures are not always made, and therefore management take risks on behalf of the owners given the consequences of misreporting or failure to report. The information choice changes from the simple binary include/exclude decision to a more complex scenario with a greater number of options. These include the possibility for managers to: exclude information but with the potential for stricter and more severe penalties; include information in its entirety regardless of the potential effect; or include in its entirety but with bias. In the latter case, this bias could stem from strategies such as quantity overload, deliberate obfuscation through presentational or rhetorical devices or by way of voluntary disclosures over and above the specific standard’s requirements. Theoretically, these strategies stem principally from impression management and legitimacy theory. Alongside proprietary costs theory, these theories underpin this study (see Section 2.6\textsuperscript{20}).

The purpose and nature of annual report disclosure is in the process of being reviewed by the IASB as part of Phase E of their current Conceptual Framework review. Comments such as those made by the ex-UK Prime Minister Gordon Brown\textsuperscript{21} - who specifically named transparency of reporting and disclosure as being central to regaining investor confidence after the peak of the financial crisis (\textit{The Times}, Oct. 2008) - highlight that disclosure is a headline issue both domestically and internationally. In the IASB’s current Framework, disclosure is highlighted as important for ensuring adherence to the qualitative characteristics of financial information: relevance; fair representation; comparability; understandability; verifiability; and timeliness. Despite the stress on the importance of disclosures from the IASB, the quality of disclosure has been singled out and criticised during the recent financial crisis for its lack of information usefulness.

\textsuperscript{20} The theoretical framework is considered in greater detail in Chapter 2 and then Chapters 4 through 7 contain a brief re-appraisal of the relevant theories in the context of that particular study.

\textsuperscript{21} The SEC Advisory Committee on improvements to financial reporting (2008: 74) criticised accounting standards on the basis that they are “sometimes obscured by dense language, detailed rules, and exceptions”. Gordon Brown, in an opinion piece for \textit{The Times} newspaper, defended the banking rescue package initiated in October 2008, and called for greater “transparency”, “disclosure” and “integrity” (\textit{The Times}, 10.10.2008).
Prior research has, for the most part, chosen to focus on voluntary disclosures – particularly social and environmental disclosures. It is worth remembering however, that for the main part, this information is unaudited and there are also doubts about whether and how this information is used by analysts and investors (Campbell and Slack, 2008). There are also other concerns about its intended obfuscatory or legitimising purpose (Bebbington et al., 2008a; Aerts and Cormier, 2009), especially when linked to issues of the proprietary costs of information (Dye, 1985, 1986, 1990). Thus, these voluntary disclosure studies have been used, specifically their theoretical underpinnings, to facilitate an exploration of mandatory financial instruments reporting practices.

It is most common for disclosure studies to assume that managers have superior information to outside investors about their firms’ prospects. It is therefore presumed that managers make accounting decisions and disclosures to communicate this knowledge to investors, and to manage reported performance for contracting, political or corporate governance reasons (Healy and Palepu, 1993, 1995, 2001).

The extant literature identifies five key factors that influence voluntary disclosure decisions for capital market purposes. Firms provide voluntary disclosures to: (i) reduce the information asymmetry associated with capital market transactions; (ii) explain away poor performance; (iii) increase the liquidity of the firm’s shares and reduce contracting costs; (iv) mitigate the threat of litigation; and (v) signal the quality of management. The unintended consequence and repercussion on companies’ reporting practices is that there is a willingness to disclose more when they have bad news because of the necessity to fulfil the factors identified (Skinner, 1994; Li, 2008; Bloomfield, 2008). It has been argued that these voluntary disclosures might be positively associated with positive signals of social accountability (Rippington and Taffler, 1995), especially in the area of social and environmental reporting (Gray and Bebbington, 2001). However, what counteracts these arguments are findings that indicate firms should be concerned that increased volume of voluntary disclosures may damage their

1.3 Compliance issues

The cornerstone of this study is a compliance review. Chapter 4 identifies levels of compliance and attempts to establish whether there are any reasons for this non-disclosure. Chapter 5 looks at the issue of over-compliance and attempts to link theory to practice. Chapter 6 adopts compliance scores as a measure of quality. Chapter 7 asks whether any group can exert pressure over the IASB and the Standard and thus have a greater chance to fulfil these requirements. Therefore, it is appropriate to provide a brief overview of prior compliance work and the conclusions derived therefrom.

1.3.1 Prior compliance work

There is a strand of accounting and audit research that has reviewed the extent and completeness related to the adoption of a single International Accounting Standard (IAS) or International Financial Reporting Standard (IFRS) (for example Tang and Conroy, 1998; Day and Woodward, 2004). It is more common, however, for researchers to focus on adoption of IAS and IFRS on a holistic basis. These studies have consistently reported high levels of non-compliance\(^{22}\) (Cairns, 1999; Tower, Hancock and Taplin, 1999; Street and Bryant, 2000; Street and Gray, 2001; Abd-Elsalam and Weetman, 2003; Glaum and Street, 2003; Chalmers and Godfrey, 2004). This problem has been linked to a number of issues, including, most notably, a lack of enforceability (Street [interview with Sir David Tweedie], 2002; Glaum and Street, 2003; Bushee and Leuz, 2005), especially in markets where disclosure

\(^{22}\) In my opinion the levels of non-compliance are significant on the basis that any non-compliance could and, in many cases, should trigger a qualified audit report which signals to the market fundamental failures and thus could lead to catastrophic risk.
levels pre-IAS were typically much lower, for example Germany (Leuz and Verrecchia, 2000).

The thrust of more current compliance research has been to use the level of compliance as part of a broader design, including analysing high (low) levels with analysts’ forecast accuracy (errors) (for example Hodgdon et al., 2008), associations with earnings management (Günther et al., 2010) and/or value relevance (Ameer, 2009; Barth et al., 2007), and investigating determinants of disclosure studies (Lopes and Rodrigues, 2007).

1.3.2 Compliance with financial instruments accounting standards

Though studies have cast doubt over the quality and completeness of financial instruments disclosures (Elmy et al., 1998; Roulstone, 1999; Chalmers and Godfrey, 2000; Chalmers, 2001; Chalmers and Godfrey, 2004; Bhamornsiri and Schroeder, 2004; Jones and Wei, 2004; Woods and Marginson, 2004; Lopes and Rodrigues, 2007; Hassan et al., 2008) and (financial) risk disclosures (Berretta and Bozzolan, 2004 & 2007; Linsley and Shrives, 2005 & 2006; Abraham and Cox, 2007) there have only been a small number of studies that have considered compliance with mandatory financial instruments and financial risk disclosures. Prior studies have had to focus on voluntary disclosures by default, and this has been a key limitation to their conclusions.

The reviews of mandatory financial instruments disclosures that do exist have been mainly US-based and they have focused almost exclusively on criticising firms’ reporting practices rather than the underlying reasons for the quality issues they have found, or even the relative strengths of the reporting. Two recent studies by Bhamornsiri and Schroeder (2004) and Jones and Wei (2004) were especially critical of the readability of the financial instruments disclosures. Bhamornsiri and Schroeder looked at the compliance with SFAS 133 disclosures for the 30 companies that comprised the Dow Jones Industrial Average, and concluded that the information was difficult to follow, lacked uniformity, consistency, comparability and ultimately therefore
decision-making usefulness. They found that a large proportion of the sampled companies declared that the value of their hedging activities was immaterial. They also observed that the derivatives information was not provided in a coherent manner and that hedging disclosure was scattered throughout the annual reports. They judged the information to be hard to understand, difficult to follow and lacking in uniformity. They claimed that even a practised and educated reviewer would find the information difficult to interpret and that there was a general lack of consistency. In addition, both Elmy et al. (1998) and Roulstone (1999) found that there were some major compliance issues related to firms’ adoption of Financial Reporting Release 48 Derivative and Market Risk Disclosures (FRR 48).

Lopes and Rodrigues (2007) investigated Portuguese listed entities’ adoption of IAS 32 and IAS 3923 and found that compliance with the mandatory reporting requirements were poor (minimum 16%; maximum 64%; mean 44%). Hassan et al. (2008) investigated the adoption of financial instruments reporting amongst Malaysian firms and found that compliance ranged between a maximum of 97.14% and a minimum of 3.57% with a mean of 33.49%. Chalmers (2001) studied a transition period in Australian financial instruments reporting between 1992 and 1998, where the disclosure environment moved from being exclusively voluntary to coercive voluntary, and finally to mandatory. As the index score increased at each phase, one can assume that the policies of coercion, and later mandating, enhanced the quality of reporting. Hassan et al. (2004) built on Chalmers’ (2001) study and examined the financial instruments disclosures between the years 1998 through 2001, and found what they considered to be low levels of compliance. However, in the context of similar studies these were reasonably high.24

23 Although it should be noted that they used an abridged disclosure index containing 54 items and therefore did not assess compliance with the full set of Standards. Note: IFRS 7 alone contains 133 separate requirements.
24 However, it is worth noting that as with other work of this sort, the disclosure index was limited to a small number of requirements and it is difficult to make claims that this is a full compliance review, rather than simply an overview of what the authors believe are the key requirements.
Amongst others, Bhamornsiri and Schroeder (2004) recommended that more work needed to be done in this area, to establish the usefulness of the information in its current format. To the best of the author’s knowledge, there has been no published work to date that seeks to measure compliance with IFRS 7 reporting requirements, to gauge the financial reporting quality of financial instruments disclosures under IFRS 7, or that seeks to investigate the relationship between the quality of this disclosure and the quantity produced.

There is another strand of research that has examined financial instruments disclosures from a value relevance perspective (see for example Barth et al., 1997; Seow and Tam, 2002 and Wang et al., 2005; and Ameer, 2009). There appears to be a flaw to this research in that it is largely based upon the initial presumption that companies are (and were) fully compliant with reporting requirements. Non-compliance is then used to rationalise inconsistent results. Without evidence of the non-compliance and its significance to the original research question(s) posed, this explanation seems inappropriate and importantly overlooks the issue of why entities are non-compliant.

Unfortunately, neither Lopes and Rodrigues (2007) nor Hassan et al. (2008) provide a guide as to what information was missing, nor do they choose to address the more important question of why it was missing. However, financial instruments and financial risk management disclosure compliance reviews have been undertaken in the US and have similar negative findings. Nissim (2003), for example, specifically examined fair value data for banks and found the information to be inconsistent. Elmy et al. (1998) argued that FRR 48 was designed to ensure disclosures of market risk were more comprehensive for derivative financial instruments. However, their overall findings were that the disclosures were not satisfactory. They perceived that the disclosures, both quantitative and qualitative, suffered from a lack of clarity, contextuality and comparability for the main part. Roulstone (1999)

25 In addition, it is worth noting that neither study looked at a full disclosure checklist. Both used a summarised checklist capturing what the researchers believed were the key requirements of the relevant Standard.
also concluded that there were some major compliance issues related to companies’ adoption of FRR 48.

1.4 The determinants of disclosures

Alongside the theoretical arguments for full, partial and non-disclosure, prior work has argued that the variances in disclosure level can be explained as resultant from the entity’s characteristics. There is only a small amount of research that has considered financial instruments specifically, and therefore a brief overview of the determinants of IAS/IFRS disclosures studies are considered first before moving on to the specific financial instruments work. It is difficult to draw general conclusions from non-specific studies (i.e. the determinants of pension reporting compliance are difficult to map to the determinants of financial instruments reporting); however the conclusions remain interesting and facilitate the drawing up of hypotheses to test in later chapters. One further benefit to identifying the prior determinants work is that it helps to guide and develop appropriate research methods.

Though this has not been discussed in the determinants of disclosure literature, the determinants of quality or quantity of one set of disclosures are intuitively less likely to be consistent to those in another area. For example, a hypothetical company might carry a large pension deficit, and disclose in detail how this position arose and the plan management has for dealing with it. This same hypothetical entity might have low levels of financial instruments and therefore the quantity and quality of disclosure required would be likely to be driven by different factors and for different reasons. On a broader basis, it might be possible for future determinants studies to follow the path of this study and provide a deeper understanding of the determinants of the quantity and quality of disclosures on a more drilled down basis. It might be possible for results to be analysed across industry and by balance as opposed to looking at the issue of total compliance with accounting standards as a whole.
1.4.1 The determinants of IAS/IFRS disclosures

Many studies have addressed the impact of corporate characteristics on the levels of disclosure quantity or compliance (of special note are studies by Cerf, 1961; Singhvi and Desai, 1971; Belkaoui and Kahl, 1978; McNalley et al., 1982; Chow and Wong-Boren, 1987; Cooke, 1989, 1991, 1992, 1993; Gibbins et al., 1990; Tai et al., 1990; Craswell and Taylor, 1992; Ahmed and Nicholls, 1994; Frost and Pownall, 1994; Hossain, Tan and Adams, 1994; Wallace et al., 1994; Gray et al., 1995; Raffournier, 1995; Wallace and Naser, 1995; Inchausti, 1997; Dumontier and Raffournier, 1998; Ahmed and Courtis, 1999; Chen and Jaggi, 2000; Watson et al., 2002; Eng and Mack, 2003; Ali et al., 2004; Akhtaruddin, 2005). Though the majority of these studies have not directly found characteristics associated with the disclosure levels of financial instruments, these studies do play a crucial role, as they aid the development of the hypotheses that this study has chosen to test (see Chapter 6).

Determinants of disclosures studies have tended to fall into two groups. Firstly, there are those that adopt a simple unweighted dichotomous measure of compliance (1) and non-compliance (0) (Cooke, 1989; Raffournier, 1995; Tarca, 2004; Cuijpers and Buijink, 2005). However, there is a growing body of research which has sought to measure compliance with an accounting standard’s various requirements and subsequently use this as the dependent variable to test other hypotheses (Tower, Hancock and Taplin, 1999; Street and Gray, 2001; Abd-Elsalam and Weetman, 2003; Glaum and Street, 2003; Chalmers and Godfrey, 2004; Lopes and Rodrigues, 2007). This ensures that

---

26 For example, a study might find a relationship between higher levels of inventories disclosures for motor vehicle manufacturers and high street retailers who typically hold large values in inventory (e.g. Rolls Royce [64.3% of net assets]; Volkswagen [37.8% of net assets]; Marks and Spencer [28.0% of net assets]; Tesco (18.5% of net assets); Sainsbury [14.1% of net assets] – all figures based on financial years ending 2009/10) rather than telecommunications for example (e.g. Nokia [6.4% of net assets]; Vodafone [0.004% of net assets]).
researchers are not simply inferring from a clean\textsuperscript{27} audit report that a firm is fully compliant. The determinants work undertaken within this study falls into the latter group. However, this project extends the work of these authors by testing not simply the determinants of disclosures but also the relationships between the levels of quality and quantity of them.

Findings from the determinants of disclosures studies have indicated that there are certain independent variables that are significantly associated with the level of disclosure. Studies have typically found that these include: size; listing status; cross listing, particularly on US exchanges; leverage; profitability; dispersion of stock ownership; industry type; Big Four auditor;\textsuperscript{28} and country of origin. These are further examined and explained in Chapter 6.

1.4.2 The determinants of financial instruments disclosures

A small number of studies have considered the determinants of financial instruments reporting behaviour. Amongst these, Chalmers and Godfrey (2004) (Australia) found positive associations with size, industry, auditor type, ownership, reputation costs and analysts following. Hassan \textit{et al.} (2008) (Malaysia) found that size, gearing (measured as debt to total assets) and the presence of a risk management committee were associated with disclosure compliance. More recently, evidence from Lopes and Rodrigues (2007) (Portugal) showed that the following were determinants for financial instruments disclosures: size; type of auditor; listing status; and economic sector. As a result of the high levels of cross listing, multi-nationality, size, strict enforcement and regulatory control in the UK\textsuperscript{29}, it is possible that

\textsuperscript{27} A ‘clean’ audit report is one which is not only unqualified but also free from any statements from the auditor which might indicate the firm had engaged in activities which were outside of normal reporting convention or normal operations.

\textsuperscript{28} Or big 5, big 6, big 8 or any of these ‘+2’ dependent upon when the research was undertaken.

\textsuperscript{29} The regulatory framework applied to financial reporting for listed group entities in the UK consists of the following main components: legislation; accounting standards; and stock exchange regulations. Legislation differs from one country to another and multinational cross-listed entities must be aware of the legal requirements of the countries in which they operate. In the UK entities are subject to the Companies Acts. Some of the rules within the Companies Act 2006 have arisen as a result of European Union Directives and are thus common across the EU financial reporting community. IASs and IFRSs are developed by the IASB which was
associations might be found elsewhere in the context of this study. However, the issues of enforceability of accounting standards for Portuguese listed companies might have been the cause for some of the rejection of the other hypotheses considered in the paper, namely multi-nationality, leverage, importance of shareholders and corporate governance. The compliance percentage ranged from 16% to 64%. In the UK, where the accounting standards are enforced to a greater extent, then it is possible that associations might be found, where elsewhere this might not be the case.

1.5 Mandatory reporting: An introduction

This project studies a relatively unexplored area of financial reporting – mandatory disclosures. A great deal of work has been carried out investigating voluntary disclosures and this study draws upon this research to help identify relevant theory and to facilitate the design. A brief introduction to the perceived role of mandatory reporting follows. This is further elaborated on in later chapters.

It has been found that voluntary disclosures can have significant benefits for both the discloser and the users of the disclosures. For the entity making the disclosures, these gains include the reduction of the cost of capital (Easley and O’Hara, 2000), increased liquidity (Diamond, 1985; Diamond and...
Verrecchia, 1991) and increased information intermediation (Diamond, 1985; Lang and Lundholm, 1996). The greater the depth and the reliability of the disclosures, the greater the opportunity to facilitate increased market discipline and prevent rumour and misleading information causing unjustifiable volatility. In addition to these benefits, there is also evidence that increased disclosure is associated positively with a corresponding increase in investor following (Eccles et al., 2001).

There has been a debate related to the advantages and problems of mandating previously voluntary disclosures (for example Dye, 1985, 1986 & 1990; Healy and Palepu, 2001; Fishman and Hagerty, 2003; Hassan et al., 2009) and these shall be developed further in later chapters. The general question posed is whether firms should be permitted to disclose information on a voluntary basis or whether disclosures should be mandated. Appeals to market failure arguments often play a central role in the arguments in favour of external regulators setting mandatory disclosure requirements (see section 2.2.3). Although these discussions are persuasive, it is worth remembering that standard setters are also imperfect and mandatory disclosures can also be manipulated by a combination of discourse strategies and non-, partial or over-compliance. Bushman and Landsman (2010: 259) suggest “that accounting standard-setting is at risk of becoming entangled in a web of political forces with potentially significant consequences”.

A further complicating factor when defining the usefulness of mandatory disclosures and measuring an entity’s compliance is the level of specificity of the requirements. The standard setters have potential problems when designing their standards in terms of the looseness of the requirement. There are mandatory disclosures with hard rules-based requirements (e.g. closed quantitative information) whilst there are others with principals driven requirements (e.g. narrative qualitative information). There is an extended debate of this issue in section 4.4.1 but one should note three possible issues that could arise. First, poorly designed requirements can make it possible for disclosing entities to fully comply but without providing useful information to users. Second, it is possible for firms to meet requirements that are more
judgemental, subjective and open ended and thus maintain compliance but without providing information which is relevant because the requirement was too loose (and thus the information asymmetry problem still stands). Third, poorly designed requirements can force companies to disclose information\(^{30}\) which is not in the interests of the stakeholders (e.g. costs outweigh benefits).

Bushee and Leuz (2005) reported that a definition of mandatory reporting should be both that the requirements themselves are mandatory and that there is a strict enforcement of those requirements. Their research found mixed results from mandating disclosures that ranged from companies simply choosing to fully comply; companies opting to trade on a different market or platform; companies choosing to delist and go private; and finally, companies choosing not to trade their equity publicly. These conclusions come in response to the direct costs (e.g. costs of compliance) and the indirect costs of mandatory requirements (e.g. audit fee increases or reputation capital costs).

There are those that believe that mandating disclosures may be unnecessary, and in some cases, harmful (Benston, 1973, 1980; Stigler, 1964; Kripke, 1979; Choi and Guzman, 1998), with some arguing for the removal of mandatory disclosure requirements altogether (Romano. 1998). In contrast, some research argues that though mandating reporting requirements does not prevent fraud, there are information benefits to both investors and intermediaries (Ferrell, 2004; Fox, 1999, 1997; Mahoney, 1995; Easterbrook and Fischel, 1994; Kahan, 1992). This study broadly holds with the opinions of those (for example Seligman, 1983) who argue that mandating disclosures in the correct context, in an appropriate manner, and within a generally accepted framework derives the greatest benefits.

1.6 The development of the mandatory financial instruments disclosures

\(^{30}\) Or the auditors can qualify the audit report if this information is withheld.
As discussed above, there are benefits to mandating disclosures and, given the scale, scope, sophistication and nature of financial instruments usage, it would seem appropriate that disclosure was not entirely discretionary. The IASB claim to have a robust, multi-stage due process (IASCF, 2008; updated 2010) when it comes to the standard setting process. This section sets out the general context for mandatory disclosures and then provides a brief summary outlining how financial instruments disclosures reporting requirements have developed and what they are.

1.6.1 Background

A Federal Reserve Bank (FRB) spokesperson, Governor Phillips (1996), stated in a speech that “[d]isclosure of reliable information facilitates market discipline, strengthens confidence, and reduces the chance that rumours and misleading information could cause market instability”. Unfortunately, empirical research has found that voluntary disclosures of derivatives-based risk management activities are relatively straightforward to manipulate (Fitch Ratings Research, 2004; Partnoy, 2002). The results of Berkman and Bradbury’s survey (1996) lend support to the notion that managers deliberately encourage firm value variability through derivatives positions, particularly when the managers share in the ownership of the firm. The disclosures of financial instruments positions and performances play an important role in this manipulation. Nevertheless, the IASB are on a pathway that seeks to ensure greater relevance, reliability, comparability, understandability, verifiability and timeliness of financial instruments disclosures. In addition, market regulators are turning to stricter enforcement and stricter penalties for non-compliance or deliberate manipulation of accounting information.

If firms are producing disclosure which does not meet the requirements as set out by IFRS 7, then the users of financial information should push for the inclusion of this material or the removal of these sections from IFRS 7. Alternatively, the preparers should be held to account for not providing information which is useful to decision-making, or/and the auditors should be
held accountable for (presumably) failing to issue a qualified audit opinion on accounts that fail to include adequate disclosure in accord with the Standard.

1.6.2 Accounting standard setters: The development of financial instruments disclosures and IFRS 7

Until the mid-1990s\(^{31}\) there was virtually no effective guidance on accounting for financial instruments, particularly derivative instruments, whether that be advice on presentation, recognition, measurement or disclosure. Companies were free to disclose as little or as much as they wished, and in practice used a wide range of disclosure methods and strategies. Most companies recorded derivatives at historical cost, which often does not convey a true picture of the risks and rewards faced. As a result, the financial statements of a company could be rendered meaningless by the non-disclosure of a financial instrument that would have had a material impact on the Balance Sheet or Income Statement.

From the late 1980s through to the 2000s, the domestic accounting standards setting bodies (e.g. FASB [US]; ASB [UK]), worked alongside the international accounting standard setters (International Accounting Standards Committee (IASC); IASB) to try to provide suitable and workable financial instruments reporting rules. The first area to be addressed was financial instruments reporting for banks. In 1987, Exposure Draft 29 *Disclosures in Financial Statements of Banks* was exposed for comment and in 1989 it was broadened to capture financial institutions including banks. In 1990 IAS 30 *Disclosures in Financial Statements of Banks and Similar Financial Institutions* (IAS 30) was released. IAS 30 was ostensibly a disclosure standard but it did attempt to address secret or hidden reserves and made financial institutions recognise potential losses through retained earnings. This attracted a great deal of criticism, particularly from European banks, but was nevertheless adopted wholesale (Cairns, 1996). In 1998 IAS 39 captured any recognition and measurement requirements but IAS 30 continued to be effective and hold

\(^{31}\) For example, in 1993 the UK standards setting body, the ASB, released Financial Reporting Standard 4 Capital Instruments.
presentation and disclosure requirements for financial institutions until it was replaced by IFRS 7.

At the same time consideration was also being given to accounting for financial instruments for non-financial firms. The IASB issued Exposure Draft 40 *Financial Instruments* (ED 40) in September 1991 and awaited commentary and feedback from interested parties. This feedback, which arose particularly from the financial services sector, was almost universally negative, and asked the standard setters what the need and potential usefulness for reporting any additional information to users might be. This negativity was echoed in board rooms and professional publications where it was claimed, amongst other things, that the information required would fundamentally lack comparability and understandability (Louis, 1997). It was clear however that action of some kind was required, primarily because accountants had always lacked a coherent framework to guide the accounting for financial instruments, and these developments were designed to facilitate improvements.

ED 40 had a wide coverage, including not only the presentation and disclosure of financial instruments but also their recognition and measurement. As a result of the volume of feedback and the complexity of the issues therein, ED 40 was modified and re-exposed as Exposure Draft 48 *Financial Instruments* (ED 48) in January 1994. The (less contentious) presentation and disclosure element was released as IAS 32 in June 1995. It is this International Accounting Standard, alongside its US counterpart Statement of Financial Accounting Standard 119 *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (SFAS 119), that has come to form the basis of recent international and domestic financial instruments disclosures.

It would be difficult to argue that this increased regulation should not be viewed in financial reporting terms as an improvement on historical disclosure provisions. However, the financial instruments accounting standards released prior to 2003 had tended to largely call for summary quantitative and
qualitative disclosures only. It was necessary to respond to the growth in usage of financial instruments that occurred during the 1990s and 2000s and, in particular, the increasing complexity of the arrangements in which these instruments existed. Thus, the financial instruments standards were extensively reviewed and revised and the requirements became more detailed. In December 2003, IAS 32 and IAS 39 were re-released using the (US) Statement of Financial Accounting Standard 133 Accounting for Derivative Instruments and Hedging Activities (SFAS 133) as a working model. By 1 January 2005, European Union listed firms preparing consolidated financial statements were required to report under IFRS, and thus IAS 32 and IAS 39 became fully effective within the international accounting community.

The IASB had always intended to revisit the disclosure issue, and in July 2004 the IASB released ED 7. This ED attracted much comment, for which it was updated, and was subsequently released as IFRS 7. IFRS 7 adopted many of the disclosure requirements of IAS 32 (with some minor exceptions) but also required firms to provide further additional financial instruments disclosures. This means that IAS 32 now carries only issues regarding presentation. IFRS 7 became effective for years commencing on or after 1 January 2007.

1.6.3 IFRS 7 requirements: Introduction

In this section it is important to set out a brief guide to the nature, scope and requirements of IFRS 7 to allow an understanding of the coverage of the standard. There are many disclosure requirements within IFRS 7 that apply only when a certain asset, liability or position exist e.g. if an entity does not hold any financial assets at fair value through profit or loss then IFRS 7.8, 7.9 through 7.11, 7.20a(i), 7.20b, and 7.20c(i) are not required. Chapter 4 has more detail about the number of requirements that should have been responded alongside the compliance results. However, for a fuller understanding of the application and design of the compliance checklist, appendix B provides an example of one randomly selected entity’s IFRS 7 compliance checklist result is provided in full. Within this section it is also
timely to acknowledge and discuss the reporting rules related to hedge accounting and the linked question of whether, and why, firms choose to adopt (or choose not to adopt) the hedge accounting rules.

1.6.3.1 IFRS 7: Background and scope

IFRS 7 was issued by the IASB during August 2005. The standard superseded both IAS 30 *Disclosures in the Financial Statements and Banks and Similar Financial Institutions* and the disclosure requirements of IAS 32. IAS 32 was subsequently renamed *Financial Instruments: Presentation* and this standard continues to govern the presentation of financial instruments in the financial statements as well as the classification of instruments as liabilities or equity, compound financial instruments, treasury shares, and the criteria for offsetting financial assets and financial liabilities [IAS 32].

The introductory paragraphs provide three reasons for the development of IFRS 7 and the continued work on the disclosure of financial instruments. These reasons are as follows. First, that “the techniques used by entities for measuring and managing exposure to risks arising from financial instruments have evolved and new risk management concepts and approaches have gained acceptance. In addition, many public and private sector initiatives have proposed improvements to the disclosure framework for risks arising from financial instruments” [IFRS 7: IN1]. Second, there needed to be enhanced disclosure of “an entity’s exposure to risks and how those risks are managed.” [IFRS 7: IN2]. It was argued by the IASB that this information is critical and could influence a user’s assessment of the position and performance of a firm. The rationale continued: “Greater transparency regarding those risks allows users to make more informed judgements about risk and return” [IFRS 7: IN2]. The third reason was a bookkeeping exercise i.e. the removal of duplicative disclosures between IAS 30 and IAS 32 plus a simplification of the disclosures about concentrations of risk (IFRS 7: IN3).

As explained above, IFRS 7 brings together the disclosures in a single standard related to financial instruments for all types of entity from their
various locations. The disclosure requirements of IAS 32 largely remain unchanged whilst IFRS 7 replaces IAS 30 altogether. In addition to being a consolidation of other standards’ requirements, IFRS 7 also introduced additional disclosure requirements. The most significant of these were:

- The requirements for enhanced balance sheet and income statement disclosure by category (i.e. the IAS 39 category classifications needed to be disclosed separately. For example, whether the instrument is ‘available-for-sale’ or ‘held-to-maturity’);
- Information on any allowance accounts and provisions against impaired assets;
- An additional disclosure relating to the fair value of collateral and other credit enhancements used to manage credit risk; and
- Market risk sensitivity analyses.

The standard covers all financial instruments whether recognised or unrecognised, except those scoped out under paragraph 3 (of IFRS 7)\(^\text{32}\), and their significance, for all entities\(^\text{33}\). The requirements apply regardless of the level of exposure to risks arising from these financial instruments. Clearly, for

---

\(^{32}\) Those financial instruments excluded include: (a) those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with IAS 27 Consolidated and Separate Financial Statements, IAS 28 Investments in Associates or IAS 31 Interests in Joint Ventures. However, in some cases, IAS 27, IAS 28 or IAS 31 permits an entity to account for an interest in a subsidiary, associate or joint venture using IAS 39; entities shall apply the requirements of this IFRS. Entities shall also apply this IFRS to all derivatives linked to interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in IAS 32; (b) employers' rights and obligations arising from employee benefit plans, to which IAS 19 Employee Benefits applies; (c) insurance contracts as defined in IFRS 4 Insurance Contracts. However, this IFRS applies to derivatives that are embedded in insurance contracts if IAS 39 requires the entity to account for them separately. Moreover, an issuer shall apply this IFRS to financial guarantee contracts if the issuer applies IAS 39 in recognising and measuring the contracts, but shall apply IFRS 4 if the issuer elects, in accordance with paragraph 4(d) of IFRS 4, to apply IFRS 4 in recognising and measuring them; (d) financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 Share-based Payment applies, except that this IFRS applies to contracts within the scope of paragraphs 5–7 of IAS 39; (e) instruments that are required to be classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32 [IFRS 7: 3].

\(^{33}\) The IASB considered the applicability of the standard to all entities – including insurers, subsidiaries and small or medium sized entities (SMEs). It was decided that they should all be included within the scope of IFRS 7 but the IASB noted that SMEs should be kept under review. The IASB have recently released an IFRS for SMEs and this reduces the number of financial instruments disclosures requirements.
a firm whose exposure is limited then the extent of disclosure will be reduced as less of the standard’s requirements will be applicable. Thus, the introduction to IFRS 7 states “the extent of disclosure required depends on the extent of the entity’s use of financial instruments and of its exposure to risk” [IFRS 7: IN4]. Both quantitative and qualitative disclosures are required and these must contain details of the methods, processes and management of credit risk, liquidity risk and market risk (plus any other relevant risks associated with financial instruments) based on the information that is provided internally to a firm’s key management personnel [IFRS 7: IN5].

1.6.3.2 Objective of IFRS 7

It is common for the disclosures of financial instruments to be material and, as noted by the IASB [IFRS 7: IN 2], impact on users’ comprehension of an entity’s position and performance. Thus the objective of IFRS 7 is to allow entities to present additional information that would aid users’ of the financial statements ability to evaluate the financial instruments usage and the risks faced as well as to gauge the amount, timing and uncertainty of future cash flows. The objectives as laid out by the standard are as follows (IFRS 7.1): “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 is a disclosure standard and further disclosures are required where it is necessary to allow users to understand the accounting choices and judgements made when applying the requirements of IAS 32 and IAS 39.

Financial instruments should be grouped into classes according to IFRS 7. Classes are not the same as the categories outlined in IAS 39. Instead, IFRS 7 requires entities to present the information in a manner that can be reconciled to the line items in the balance sheet. Thus, IFRS 7 requires that there should be a differentiation between those instruments held at fair value
and those held at amortised cost. In addition, there should be a separate class for those instruments that are outside the scope of IFRS 7. The guidance notes to IFRS 7 [B3] issue the caution that it is necessary for preparers to “strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation.”

The two key objectives of IFRS 7 relate to: significance of financial instruments; and the nature and extent of risks arising from financial instruments. Therefore, a brief outline of the main disclosures that ensure these objectives are met follows. For the purposes of this section, hedge accounting has been moved to a separate sub-section for further and separate consideration.

(i) Significance of financial instruments

- Carrying amounts: IFRS 7.8 states that the carrying amounts of each of the following categories of financial asset and liability shall be disclosed either in the statement of financial position or in the notes to the financial statements:

  “(a) financial assets at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with IAS 39;
  (b) held-to-maturity investments;
  (c) loans and receivables;
  (d) available-for-sale financial assets;
  (e) financial liabilities at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with IAS 39; and
  (f) financial liabilities measured at amortised cost”
• Reclassifications: Reclassifications of financial instruments from one category to another [IFRS 7.12]

• Collateral: Information about financial assets pledged as collateral and about financial or non-financial assets held as collateral [IFRS 7.14-15].

• Allowance accounts for credit losses: IFRS 7.16 sets out the requirements for disclosing any allowance accounts for credit losses. The standard states: “When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g. an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets”.

• Multiple embedded derivatives: IFRS 7.17 requires information about compound financial instruments with multiple embedded derivatives.

• Breaches: IFRS 7.18-19 requires an entity to disclose information about any breaches of terms of loan agreements.

• Fair value: IFRS 7.25 describes the treatment required for recognition of fair value. The standard states: “For each class of financial assets and financial liabilities an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.” Fair value disclosure is not required for those assets and liabilities scoped out of the standard nor is it required for those assets or liabilities where fair value cannot be measured reliably (see IFRS 7.29 for further details).

• Items of income, expense, gains and losses: IFRS 7.20 outlines the disclosure requirements in the statement of comprehensive income and specifies how an entity should disclose items of income, expense, gains and losses. The requirements are as follows: (a) net gains or net losses on each class of financial asset and liability; “(b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss; (c) fee income and expense (other than
amounts included in determining the effective interest rate) arising from: (i) financial assets or financial liabilities that are not at fair value through profit or loss; and (ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions; (d) interest income on impaired financial assets accrued in accordance with paragraph AG93 of IAS 39; and (e) the amount of any impairment loss for each class of financial asset.

- Accounting policies: In terms of accounting policies, IFRS 7.21 states that “In accordance with paragraph 117 of IAS 1 Presentation of Financial Statements (as revised in 2007), an entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.”

(ii) Nature and extent of risks arising from financial instruments

IFRS 7.31 states that “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”. Paragraph 32 identifies the three principal risk types as credit risk, liquidity risk and market risk. IFRS 7.32 does state that the risks are not limited to these three types and entities must consider their own exposure on a case-by-case basis. The appendix of IFRS 7 defines these risks as follows:

- Credit risk is “the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation”.
- Liquidity risk is “the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset”.
• Market risk is “the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.”

For each of these risks the Standard requires both qualitative and quantitative disclosures. The qualitative disclosures require the entity to disclose a description of: “(a) the exposures to risk and how they arise; (b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and (c) any changes in (a) or (b) from the previous period” [IFRS 7.33]. Paragraph 34 sets out the quantitative disclosures that require an entity to disclose: “(a) summary quantitative data about its exposure to each [sic] risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in IAS 24 Related Party Disclosures), for example the entity’s board of directors or chief executive officer; (b) the disclosures required by paragraphs 36–42, to the extent not provided in (a), unless the risk is not material...; (c) concentrations of risk if not apparent from (a) and (b).

In addition there are specific detailed disclosures related to each of these three types of risk. For each class of financial asset an entity must disclose the following in relation to their credit risk: (a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements; (b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancements; (c) information about the credit quality of financial assets that are neither past due nor impaired; and (d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated [IFRS 7.36]. With regards to liquidity risk an entity must disclose a maturity analysis [IFRS 7.39(a)&(b)] and a description of how it manages any inherent liquidity risk [IFRS 7.39(c)]. In relation to market risk there is a specific requirement to disclose a sensitivity analysis “for each type of market risk to which the entity is exposed at the end..."
of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date”. In addition the entity must disclose “the methods and assumptions used in preparing the sensitivity analysis” and any “changes from the previous period in the methods and assumptions used, and the reasons for such change” [IFRS 7.40].

1.6.3.3 Hedging and hedge accounting

Hedging as a risk management strategy or practice is a much wider issue than hedge accounting and is not the principal subject of this project. In addition, hedge accounting rules are the domain of IAS 39 whereas IFRS 7, the subject of this thesis, is concerned with the disclosure of financial instruments and not their recognition and measurement. However, these issues are intertwined and therefore a brief analysis of the economic rationale ‘for’ hedging is provided in Section 2.4 as this supports later assertions. Also, here follows a brief discussion of hedge accounting to enable an understanding of the significance of the disclosures made by an entity both when it elects to apply hedge accounting and when it does not. In addition, it is important to set hedge accounting in context and thus some consideration is provided as to why a firm might opt not to hedge account even where the hedge accounting criteria are met.

A study by Duangploy and Helmi (2000) investigated foreign currency hedge accounting in a US setting but alongside this noted the related problems prior to SFAS 133 (which is closely related to the IASB standards IAS 32, IAS 39 and IFRS 7). The key problems identified by the FASB and other stakeholders according to Duangploy and Helmi (2000: 232; see also SFAS 133.234-237) were: incomplete accounting guidance for derivatives and hedging; inconsistent accounting guidance for derivatives and hedging; difficulty in application of guidelines; and a lack of transparency of the effects of the derivatives in the basic financial statements. They argued that there are still problems with SFAS 133 but that these problems were at least addressed. Hedge accounting was designed to be appealing to entities because it permits a decrease in the volatility of earnings which is associated with fair value
accounting. Michelson et al. (1995) argued that managers disliked increased earnings volatility because it indicated increased riskiness. Graham et al. (2005) followed up this with the argument that this increased volatility made it more difficult for managers to hit earnings-based targets.

IAS 39.9 provides definitions of the key ingredients that relate to a hedge: the hedging instrument and the hedged item. These are as follows:

- **A hedging instrument** is a designated derivative or a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

- **A hedged item** is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged.

Related definitions are as follows:

- **A firm commitment** is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

- **A forecast transaction** is an uncommitted but anticipated future transaction.

Under international financial reporting standards there are three types of hedging relationship: fair value hedge; cash flow hedge and net investment hedge (IAS 39.89-102). However, as alluded to above, to categorise any financial instruments under any of these headings and apply hedge accounting techniques there are a number of conditions that need to be met. These conditions seek to ensure that only genuine hedging instruments should be recorded as hedge accounted items and thus in turn, they aim to make sure that users of financial statements can clearly identify hedged positions. The conditions for hedge accounting are as follows (all conditions must be met) [IAS 39.88]:

Page 42
a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value or cash flows attributable to the hedged risk.

b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

d) The effectiveness of the hedge can be reliably measured, i.e. the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.

e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Hedge accounting is sometimes considered as a way to balance out the deficiencies of the mixed measurement model applied in international accounting standards. As PwC’s guide to Achieving Hedge Accounting (December 2005) explained: “The basic principle in IAS 39 is that all derivatives are carried at fair value with gains and losses in the income statement. However, derivatives are commonly used to hedge recognised assets and liabilities that are measured at cost, amortised cost or at fair value with gains and losses recognised in equity or items such as forecast

34 IAS 39.9 defines hedge effectiveness as “the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.”
transactions or firm commitments that are not recognised in the balance sheet. This creates a mismatch in the timing of gain and loss recognition. Hedge accounting seeks to correct this mismatch by changing the timing of recognition of gains and losses on either the hedged item or the hedging instrument. This avoids much of the volatility that would arise if the derivative gains and losses were recognised in the income statement, as required by normal accounting principles.” Thus, the designation of the derivative determines the changes in fair value reported in the financial statements (Hughen, 2010). Where hedge accounting is applied an entity will typically match to the same period(s) any gains or losses on a hedging instrument with any gains or losses that arise on the hedged item(s). There are several situations where this matching might not otherwise occur e.g. measurement differences between the hedged position and hedging instrument; performance reporting differences – where gains or losses are reported in a different place in the financial statements and thus creating a reconciliation mismatch; recognition differences; and existence difference i.e. where the hedge is of cash flows from a transaction that does not exist yet (for example, because it is uncontracted). Hedge accounting allows results to be reported in a smoother pattern.

A fair value hedge relates to the hedge of the exposure to a change in fair value of a recognised asset or liability or an unrecognised firm commitment that will affect reported net income. The basic accounting treatment for dealing with a fair value hedge are that for a derivative hedging instrument, the gain or loss arising from the re-measurement of the hedging instrument to fair value is recognised in the income statement (statement of comprehensive income) in the period. The hedged portion of the hedged item will also be re-measured to fair value and all gains and losses will be reported in the income statement (statement of comprehensive income). Any foreign currency component of the carrying amount of a non-derivative hedging instrument held in a fair value hedge should be accounted for using the rules of IAS 21 The Effects of Changes in Foreign Exchange Rates and recognised in the income statement.
The hedging instrument held in a cash flow hedge relationship will be re-measured at fair value and the gain or loss on the portion of the instrument that is deemed to be effective will be taken to equity and recognised in the statement of changes in equity. The ineffective portion of the gain or loss will be taken directly to the income statement immediately. One notable complication arises where the hedged item results in the recognition of a non-financial asset or liability at the conclusion of the hedging arrangement and there is a carried gain or loss in equity. Where this is the case, the gain or loss can either be set off against the carrying amount of the non-financial asset or liability; or the gain or loss can be transferred to the income statement matched with the consumption of the non-financial asset or liability.

The treatment of a net investment hedge or the hedge of an investment in a foreign entity is similar to that of a cash flow hedge inasmuch as the gain or loss on the hedging instrument should be recognised directly in equity to match against the gain or loss on the hedged investment.

1.6.3.4.1 Hedge accounting disclosures requirements

Paragraphs 22 through 24 of IFRS 7 cover the hedge accounting disclosures requirements. Paragraph 22 asks that for each type of hedge (i.e. fair value hedges, cash flow hedges and hedges of net investments in foreign operations) an entity discloses: “(a) a description of each type of hedge; (b) a description of the financial instruments designated as hedging instruments and their fair values at the end of the reporting period; and (c) the nature of the risks being hedged”. Paragraph 23 then details some extra disclosure requirements for cash flow hedges including details of: “(a) the periods when the cash flows are expected to occur and when they are expected to affect profit or loss; (b) a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur; (c) the amount that was recognised in other comprehensive income during the period; (d) the amount that was reclassified from equity to profit or loss for the period, showing the amount included in each line item in the statement of comprehensive income; and (e) the amount that was removed
from equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction”.

IFRS 7.24a requires an entity to disclose information any gains or losses resultant from changes in the fair value of either the hedging instrument or the hedged items in any fair value hedges. IFRS 7.24b-c states that a company must disclose any ineffectiveness recognised in profit or loss on cash flow hedges and hedges of net investments in foreign operations.

1.6.3.4.2 Why might entities choose not to apply hedge accounting?

As stated above, the hedge accounting rules are intended to present the results of hedging activities more transparently and thus the IASB have designed a system for accounting for derivatives under the hedge accounting rules that is meant to be simpler and carry more appeal. However, entities might elect not to employ this accounting treatment and instead designate their instruments as held for trading (or derivatives not held in hedge accounting relationships). The IASB are currently consulting on the issue of hedge accounting rules and have released an exposure draft35 (December 2010). They noted (IASB, 2010: 3) that the “existing hedge accounting requirements... were developed when hedging activities were relatively new and not as widely understood as they are today.” This snapshot review document continues “Many investors believe that the current... hedge accounting requirements... present [information that is] arbitrary and too rule-based, and they argue for a closer alignment with risk management.” The hedge accounting rules under IAS 39 make it burdensome to apply to groups

35 This exposure draft deals with general hedge accounting and an exposure draft related to macro hedge accounting will follow during the third quarter 2011. This exposure draft is under review following the close of the comment letter period on 9 March 2011. The IASB will discuss the progress of this exposure draft and intends to put the decision out for ballot during the latter half of 2011. The key points to note related to this exposure draft are: Hedge accounting would be integrated with risk management activities; Eligible hedged items would include certain risk components of non-financial items and certain groups of items; Quantitative threshold and retrospective assessment for hedge effectiveness testing would be eliminated; Fair value hedge mechanics would be adjusted to align closer with current cash flow hedge mechanics; Hedges would be rebalanced instead of restarted (however, voluntarily discontinuing would be prohibited); Time value component of purchased options would be accounted for in other comprehensive income.
of items (portfolio hedging is common for financial entities) and also to individual components of non-financial items. The consultation phase also suggested that there is unnecessary confusion between fair value hedge requirements and cash flow hedge requirements. Finally, the feedback showed evidence of dissatisfaction with the disclosure requirements on the basis that they do not provide “enough information about [an entity’s] risk management activities” (p.1 & 3).

Another set of reasons why reporting entities might wish to ignore the hedge accounting rules to reflect the reality of their hedging activities arises during the pre-transaction phase. An entity that wishes to employ hedge accounting rules needs to make the decision up-front i.e. in advance of the purchase of the hedging instrument. For a hedge to be accounted for under hedge accounting rules the criteria listed above need to be met. For a firm that does not already employ hedge accounting then the set-up costs can be a barrier, especially the costs associated with monitoring hedge effectiveness. Kawaller (2002) found that one-quarter of survey respondents chose not to employ hedge accounting rules to avoid the rigorous testing and documentation requirements. Donal Mulligan, the Chief Financial Officer of General Mills, reported in the firm’s 2008 annual report that the company had ceased using hedge accounting because of “the rising compliance costs and the complexity associated with the application of hedge accounting” (quoted in Rapoport, 2008).

The impact on the disclosures and the results can be significant and one interviewee for this project (6: treasury director) reported that one of the failings of the financial instruments standards lies in the fact that it scopes out many of the hedging arrangements in place because they are not strictly financial instruments. He argued: “all [of these arrangements] make up part of our economic or operational hedging, depending how you look at that, but only part of it will be scoped into our, say, hedging disclosures. The only part to be scoped into our hedging disclosures are those contracts that meet the definition of a derivative under IAS 39. There’s actually then another, whole other category of contracts that are not scoped into say, our hedging
disclosures, those contracts economically they’re good hedges but we’re not accounting for them as IAS 39 accounting hedges.” He continued, “there’s a whole other series of contracts that we’re not even marking to market, we’re not recognising them as financial instruments even though economically they’re still hedges.”

Comiskey and Mulford (2008) undertook a survey related to the appeal (or lack of) of the application of hedge accounting rules and found four explicit reasons why entities might elect not to designate their derivatives as hedging instruments despite (potentially) meeting the criteria. These were (p.3): “(1) the substantial cost of documentation and ongoing monitoring of designated hedges; (2) the availability of natural hedges that can be highly effective; (3) a new accounting standard that broadens the applicability of natural or economic hedges; and (4) qualifying hedges are not available or are too costly or documentation is untimely, inadequate, or unavailable.” Hughen (2010) picked up a fifth reason from Comiskey and Mulford’s work. They reworked three years worth of data for entities that apply hedge accounting rules and found that reported earnings could increase by as much as 38% or decrease by 25% if the treatment was ceased. Hughen (2010) found that between 2001 and 2007, more than 100 US firms were forced to reconsider their treatment of derivatives reported under hedge accounting rules because they failed to meet the hedge accounting criteria. Thus, the issue of possible earnings restatements might be considered as a significant factor.
Chapter 2: Literature review

2.1 Introduction

This chapter provides a critique of the literature relevant to this study. In each of the small-scale studies in chapters 4 to 7 the relevant literature is developed in greater detail. The majority of prior work investigating financial instruments originates largely in the US financial reporting and finance communities. However, in recent years the level of global contributions has grown significantly, attracting input not only from the UK but also from Europe, Australasia and Asia. It should also be noted that the financial instruments literature is almost exclusively dedicated to derivative financial instruments, and the risks arising from them and their (mis-)management.

The starting point for this literature review is to set this study in context and to highlight the position and importance of corporate disclosures and disclosure practices and strategies. The review firstly includes a brief discussion of the work which has considered financial instruments reporting and the associated advantages and disadvantages of making reporting requirements mandatory. In addition, there is an outline of the work which has sought to assess the value relevance of financial instruments disclosures, thus reaffirming the importance of these disclosures from an economic perspective.

The majority of prior literature in this area addresses the question of whether to hedge or not. Some firms will choose to use financial instruments to hedge transactions whilst others will avoid them despite the (potential) associated benefits. This review then briefly turns to the economic rationale for using (derivative) financial instruments as hedging instruments. It is important to understand the underlying rationale for using derivatives, as this guides our understanding of the possible purpose(s) of the disclosure.

This review continues to a discussion of the underpinning theoretical considerations beyond the basic economic rationale. These theories are predominantly explored in a voluntary reporting environment and therefore
this overview also contains reference to social and environmental disclosure research.

2.2 An overview: Financial instruments reporting requirements

2.2.1 Background

As evidenced in Section 1.1.2, (derivative) financial instruments usage has grown significantly and rapidly in recent times. In the case of many financial and non-financial companies, financial instruments contribute significantly to the success or otherwise of their operations. This phenomenon, alongside various high profile derivatives-related corporate failures (e.g. Barings; 1995), has put increased pressure on global accounting standard setters to ensure that financial instruments’ positions and performance are recorded appropriately in the annual report and financial statements.

However, researchers have consistently argued that derivatives are predominantly used to reduce the volatility in earnings which in turn impacts positively on (perceived) risk and lowers the cost of capital (for example Geczy et al., 1997). Therefore, this argument follows that as hedging is a risk reduction strategy,36 a company that adopts an efficient hedging policy has also, by default, moved towards a value maximisation programme. Thus firms should be encouraged to use derivatives as hedging instruments.

Thus, the key for standard setters and considerations related to financial instruments reporting requirements is to ensure that the problems associated with the reporting are mitigated, and that the qualitative characteristics of reporting (namely: relevance; faithful representation (reliability); comparability; understandability; verifiability; and timeliness) are fulfilled. These dual objectives must be struck in balance with certain important issues such as: the feasibility with which companies can fulfil the information demands of the requirements; the perceived credibility of the disclosures; the ability of

---

36 There is some debate about whether risk aversion and risk reduction are positively rewarded in this way; however this is not considered here.
investors to interpret the disclosures; the ability of enforcers to ensure these requirements are met; and finally, the ability of the companies themselves to be able to justify the costs of meeting these requirements in a timely manner to their shareholders.

2.2.2 Financial instruments: The reporting problem

As outlined in Section 1.1, an understanding of a company’s financial instruments – and especially derivative financial instruments – assets, liabilities, gains and losses is crucial to an understanding of the company’s financial performance and position. Thus, the crux of the reporting problem is what value to report (measurement), plus when and where to report the movements of the instruments in the financial statements (recognition, presentation and disclosure). This debate originates in the fact that derivatives have either a very low or zero historical cost\(^\text{37}\), and therefore their economic reality, value and volatility were historically obfuscated prior to IAS 32, IAS 39 (and subsequently IFRS 7) as companies could, to all intents and purposes, legitimately carry instruments off-balance sheet. In which case, the associated financial information reported was limited in both quantity and usefulness.

Gebhardt et al. (2004), Whittington (2005) and Sapra and Shin (2004) identified another significant problem that exists(-ed) under IAS 39 reporting requirements. This problem related to the ongoing prospect of measurement mismatches arising on assets and liabilities due to the mixed-attribute model which combines fair value, historic cost and hedge accounting\(^\text{38}\). Gebhardt et al. showed, using a simulation model methodology, that there are potential unusual valuations of derivatives and that volatility might not be reflected in the income statement for cash flow hedging – but cannot be excluded from

\(^{37}\) As described in section 1.1.1, IAS 39 defines a derivative as financial instrument or other contract that meets three characteristics, the second of which is: 2) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

\(^{38}\) Section 1.1.1 provides a definition of hedge accounting (including cash flow hedging; fair value hedging; and the hedge of a net investment in a foreign operation) whilst section 1.6.3.3 contains a brief discussion of these three forms of hedge accounting and a description of the accounting treatment for each.
comprehensive income, which analysts tend to use when valuing a firm. In addition, Hernández Hernández (2003) argued that only one model should be used to report derivatives to ease the comparability and transparency problems created.

Nevertheless, as outlined in Section 1.8, the financial instruments reporting requirements have developed significantly over the last decade, into a robust sequence of both principles-based and rules-driven presentation, recognition, measurement and disclosure requirements. Global standard setters continue to rigorously review all of these issues, taking keen and particular interest regarding the complexity of the requirements and the reported qualitative and quantitative information.

2.2.3 The bridge between voluntary and mandatory disclosures and the rationale for mandating reporting requirements

There is evidence that voluntary disclosure can have significant benefits and these are outlined in section 1.5 above. Only occasionally does the literature spill over from voluntary disclosure into discussions of mandatory reporting and the merits, demerits, advantages and disadvantages thereof (Leuz, 2010). See Tables 3 and 4 for a summary of the main potential costs and potential benefits of producing informative voluntary disclosures (table 3) and the main advantages and disadvantages of reporting mandating requirements (table 4).

Holland (1998; 2005) undertook research investigating disclosure rationale using a grounded theory approach. He argued that there was ample room for discretionary private disclosures over and above the public mandatory disclosures and there was a bias towards private disclosure. Holland (1998: 30) argued that this was because of the “benefits of private exchange, the limits of public disclosure mechanisms especially of financial reporting, and managerial opportunism and preferences.” Though this relationship
undoubtedly still exists\textsuperscript{39}, and institutions strike their balance between the market benefits of public disclosure ("liquidity and cost of capital" [Holland, 1998: 64]) without threatening or undermining the benefits of private disclosure ("maintain control of company, maintain job, secure funds and support when required" [Holland, 1998: 64]), the standard setters have argued (e.g. IASCF, 2008 [updated 2010] [Due process]; IASB, 2010 [How We Consult]; IASB, 2011 [Who we are and what we do]) that much of their work has been focused towards narrowing this gap. These words are backed up by actions from the IASCF who have established monitoring bodies and enhanced their visibility and powers (e.g. Due Process Oversight Committee [DPOC]\textsuperscript{40}). In addition, one of the ways that this problem has been addressed in recent accounting standards (such as IFRS 7 and IFRS 8) is to ask for disclosures to be through the eyes of management and thus to make more of the private disclosures public by default.

The main focus of the later study was voluntarily produced information however the research also crossed over and has implications for mandatory disclosure practices. Holland (2005) reviewed a number of cases and conducted interviews (25) with key information preparers and users and analysed their disclosure behaviour. The key question the paper addressed was about the release of voluntary disclosure through public and private channels and whether there was a learning effect. The findings suggested that there were four levels of disclosure: public mandatory disclosure; semi-private disclosure; private disclosure; and secrecy i.e. no disclosure). With regard to the first and last of these (which are of most concern to this project), Holland argued that the evidence suggested that the primary objective of public disclosure was to fulfill mandatory reporting requirements and to release price sensitive information where there was major change\textsuperscript{41}. Secrecy

\textsuperscript{39} Arguments such as “the human side of communication” and in particular, “seeing the whites of eyes of the management” (Holland, 1999: 51) in a face to face discussion, will always be a valuable resource for those seeking to interpret information.

\textsuperscript{40} DPOC established in 2006. The 2010 annual report contained the action point to make the work of the Committee more public and transparent by placing meeting information/documentation on the IASB website (which they have done).

\textsuperscript{41} This argument was echoed later in the paper when interviewees note that new market conditions or new entrants forced the greatest pressures on information availability.
was maintained where information was either: competition sensitive; to the disadvantage of management; or constrained by company culture, opinion status and circumstance. Holland (2005) also noted that his interviewees argued that more (voluntary) disclosure tended to be released when a financing issue occurred and less (voluntary) information was released when performance declined. The final issue Holland raised that is significant to this study related to confidence. The study found that information release was linked to improving, introducing, maintaining or stabilising confidence levels.

Prior work has outlined various advantages to mandating disclosures (e.g. attracting investors) (for example Healy and Palepu, 2001; Hassan et al., 2009). However, the conclusions of these papers in relation to the cost-benefit trade-off are mixed (Fishman and Hagerty, 2003). Jorgensen (1997) showed that sub-optimal hedging strategies are employed where mark-to-market hedge accounting is adopted. A related study conducted by Melumad et al. (1999) divided up the objectives of potential and current shareholders and then further sub-categorised investors as short-term and long-term. Within this division they found that there were varying optimal positions and differing preferences over hedge accounting methods.

Bushee and Leuz (2005) reported that a definition of mandatory reporting should be both that the requirements themselves are mandatory, and that there is a strict enforcement of those requirements. Their conclusions come in response to the direct costs (e.g. costs of compliance) and the indirect costs of mandatory requirements (e.g. audit fee increases or reputation capital costs). Hassan et al. (2009) investigated an environment where there are mandatory reporting rules; however, the power to enforce these rules is not strong (Egypt42). They found a negative association between mandatory disclosure compliance and firm value and concluded that this is because of the lack of enforcement. They suggested that greater compliance could be achieved with higher penalties.

42 According to the World Governance Index designed by Kaufmann, Kraay and Mastruzzi, which is often the benchmark for corporate governance researchers when identifying the strength of a country’s procedures and processes, Egypt ranks 97th (out of 213) in the Rule of Law category (which is the most appropriate measure of the strength of a system).
Table 3 The main potential benefits and potential costs of informative voluntary disclosure

<table>
<thead>
<tr>
<th>Potential benefits</th>
<th>Potential costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Enhanced credibility and improved investor relations</td>
<td>• Competitive disadvantage if sensitive information disclosed</td>
</tr>
<tr>
<td>• Access to more liquid markets and improved pricing/decision making capabilities</td>
<td>• Bargaining weaknesses related to stakeholders</td>
</tr>
<tr>
<td>• Reduced perceived risk, increased reputation and lower cost of capital</td>
<td>• Increased litigation risk</td>
</tr>
<tr>
<td>• Reduced litigation risk</td>
<td>• Preparation and audit costs</td>
</tr>
</tbody>
</table>

Table 4 The main disadvantages and advantages of mandating reporting requirements

<table>
<thead>
<tr>
<th>Disadvantages</th>
<th>Advantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>It has been argued that mandating the reporting of information could:</td>
<td>It has been argued that mandating the reporting of information could:</td>
</tr>
<tr>
<td>• prevent an efficiently functioning free market;</td>
<td>• promote a more robust system of corporate governance and attract investors;</td>
</tr>
<tr>
<td>• impose an unfair tax on shareholders through the direct and indirect costs of producing information;</td>
<td>• force managers to focus on key areas;</td>
</tr>
<tr>
<td>• lead to competitive disadvantage as companies are forced to release sensitive information;</td>
<td>• ensure stakeholders, especially investors and analysts, enforce management’s fiduciary duties and thus contribute to the alleviation of the agency problem;</td>
</tr>
<tr>
<td>• lead to the loss of useful voluntarily disclosed information when entities are forced to move to compliance with mandatory requirements; and</td>
<td>• (and linked to the above point) provide a level of public enforceability which would be beneficial to the credibility of disclosures;</td>
</tr>
<tr>
<td>• lead to the loss of meaning through a process of producing boiler-plate information.</td>
<td>• create pressures from externalities which allows some equalisation to the information asymmetry issue;</td>
</tr>
<tr>
<td>Other disadvantages include:</td>
<td>• save costs to the economy as a whole (as users do not have to</td>
</tr>
</tbody>
</table>
Aside from two recent papers – one by Bushman and Landsman (2010) and the other by Leuz (2010) – research has, by and large, remained relatively silent on the underlying rationale for making corporate disclosures mandatory. There are a small number of accounting commentators who believe that mandating disclosures prevents an efficiently functioning free market (Henderson, 2001) and imposes an unfair tax on shareholders (Teather, 2003). Others hold that mandatory disclosures encourage internal improvements such as: promoting a more robust system of corporate governance; forcing managers to focus on key areas; and ensuring stakeholders, especially investors and analysts, enforce management’s fiduciary duties. Some research has argued that opportunism and optimism drive some disclosure decisions and this pollutes mandatory and voluntary disclosures alike (Holland, 1998; 2005). Opportunism might exist in the form of: allowing managers to explain away poor performance; increasing the liquidity of the firm’s shares and reduce contracting costs; reducing litigation risks; and guiding perceptions of management performance and behaviour (e.g. Healy and Palepu, 2001; Leuz and Wysocki, 2008; Holland, 1998).

43 Available at: http://mises.org/daily/1280.
Leuz (2010) holds that there are four advantages to mandating disclosures: first, that this creates pressures from externalities; second, a mandatory regime can save costs to the economy as a whole (as users do not have to bargain for the information privately [Ross, 1979]); third, that this provides a level of public enforceability which would be beneficial to the credibility of disclosures; and finally, “it makes it easier for new entrants to commit to transparency so that they can raise the necessary capital to exploit opportunities forgone by the incumbents... [and] it may also make it harder for controlling insiders to consume private benefits and thus mitigate the root cause of the problem” (p. 231). Legal and economics theorists\(^{44}\) have given special attention to the debate about mandating corporate disclosures.

Opinions and conclusions are divided and there is polarisation to both ends of the continuum.\(^{45}\)

On the one hand, in a regulatory setting, the impossibility theorem states that no decision criteria may exist to facilitate the most socially desirable accounting policy options (Demski, 1973). It is also not clear whether the public interest theory of regulation of accounting adequately describes the actual practices of standard setting. Regulators may be captured to protect the interests of certain groups (Posner, 1974) or regulations instituted to serve the private interests of certain parties (Stigler, 1971; Peltzman, 1976).\(^{46}\)

On the other hand, current research has argued that despite the direct and indirect costs of mandatory reporting rules adoption, stakeholders should support reporting regulations even if they are not the ideal solution.

\(^{44}\) Though there are references in the accounting, finance and economics literature, the theoretical justifications are provided in greater detail and with more authority in the legal academic research. The accounting, finance and economics literature tend to arrive at the same conclusions but through different routes. For example, Board (2009) discusses mandatory requirements over product quality, and concludes this would benefit market efficiency and competition. Huang (2008) refers to insider information disclosures and the mandating of this to improve market liquidity (provided there is risk neutrality). Whilst Hassan et al. (2008: 2) found that “well packaged and timed regulations can foster sustainable development in the overall reporting environment of a country”.

\(^{45}\) There is also a body of legal research that investigates mandatory disclosures associated with other contexts, e.g. food labelling or pharmaceuticals data. This literature is ignored in this study.

\(^{46}\) These notions will be discussed in more detail in the theory section of this chapter.
(Easterbrook and Fischel, 1994; Mahoney, 1995; Dennis, 1987). Importantly, the conclusions derived by legal research echo those from the accounting, finance and economics literatures. Though mandating reporting requirements does not prevent fraud (as exhibited in recent corporate collapses) there are information benefits to both investors and intermediaries (Easterbrook and Fischel, 1994; Fox, 1999; Fox, 1997; Kahan, 1992; Ferrell, 2004), principally arising from the reduction of information asymmetry, the reduction in agency costs (Mahoney, 1995; Ferrell, 2004), and improving market efficiency and pricing competition (Fox, 1997; Ferrell, 2004). On balance, mandating disclosures in the correct context, in an appropriate manner, and with a generally accepted framework, allows a combination of the above benefits (Seligman, 1983).

2.2.4 The impact of mandatory disclosure requirements on the qualitative characteristics and accounting systems

The problem faced by standard setters when mandating complex reporting areas such as accounting for financial instruments is that, regardless of the standard setters’ authority, knowledge, tenacity and commitment to a high quality set of guidance, the disclosure is almost destined to fail to achieve its desired aims. Notably, there is a compromise between the qualitative characteristics, with one quality offset against another.

It has been argued that reliability and relevance suffer equally where mandatory disclosure requirements enforce generic reporting (Woods and Marginson, 2004). This problem is exacerbated where agency conflicts exist alongside the desire and ability to obfuscate or manipulate key information (Lambert, 2005). Relevance further suffers where mandated numerical and narrative disclosures are inappropriately required, and thus critical information can be too easily obfuscated by the volume or quantity of information. Intuitively, on first examination it would appear that additional risk

\[47\] For example, as a result of industry-driven changes in risk management practices e.g. more sophisticated instruments or techniques rendering disclosures obsolete, out of date or requiring inappropriate information.
assessment disclosures are useful for making comparisons across businesses in the same sector and from other sectors, thus facilitating comparability and understandability. However, comparability and understandability can be impaired due to significant variations in both the quality and quantity of disclosure. Due to the complexity of financial instruments reporting and given the first-time adoption concerns and many open-ended principles-based disclosure requirements, this variability will be accentuated. Understandability can be further undermined where a standard does not force certain fundamental numerical and narrative disclosures. Furthermore, researchers have argued that a loss of transparency has been the most significant victim of the new reporting requirements (for example, see Hernández Hernández, 2003; Supanvanij and Strauss, 2006).

The fair value reporting criteria included within IAS 39 and the associated disclosure requirements of IFRS 7 have been a significant battleground for those opposed to the financial instruments accounting standards and those that support them. It was clear from the outset of the standard setting process that the IASB agreed with the core principles of fair value accounting for financial instruments. The IASB Task Force (Task Force) and the Association for Investment Management and Research (AIMR) responded to the Joint Working Group’s (JWG) draft financial instruments standard by stating that they firmly supported the fair value principles promoted therein (Damant, 2002).

One of the key reasons for this support was that the disclosures associated with fair value accounting would be beneficial to shareholders. The Task Force stated that the application of fair value principles would facilitate transparency of the true economic consequences that they referred to as “vital financial and nonfinancial information” (Damant, 2002: 12). The Task Force argued that fair value principles would promote a greater degree of relevance.

---

48 However, I find evidence that challenges this intuitive premise in Chapter 8 and therefore we shall return to it later.
than historic cost accounting, and understandability would be provided as a result of improved disclosure transparency. 49

Those that opposed the fair value criteria listed amongst their concerns the potential for agency conflicts resulting directly from this increased transparency. It was argued that amongst these conflicts was the reduction (or increase) of derivatives activity when managerial compensation packages included equity-based compensation such as share options or share issues (Supanvanij and Strauss, 2006).

The financial instruments reporting requirements, alongside the fair value disclosures requirements, have been heavily criticised for their information content (see for example Woods and Marginson, 2004). Specifically there are issues related to the categorisation of financial instruments and therefore the inability of analysts to compare risk exposures from one firm to the next, if the categorisation is different. In addition, it has been stated that it is almost impossible to untangle financial instruments positions and separate out positive and negative fair value movements. The more complex a company’s positions become then the more tangled the performance of their financial instruments becomes. A further issue related to fair value disclosures is that some instruments do not participate in an active market and thus are not traded regularly. These will be valued using discounted cash flow methods (or similar) and these are subject to management discretion.

In line with prior academic research (for example Bradbury, 2003) the Task Force acknowledged and conceded that reliability, though important to an understanding of the economic reality, is a constraint to greater relevance (Damant, 2002). Prior work has claimed that the fair value criteria meant that there were valuation anomalies where many financial instruments could not be reliably measured at fair value, due to their non-marketability – and that this potentially unreliable measurement would impact on income volatility.

49 See section 1.5 for a brief discussion of the problems associated with loosely worded arguments but also see section 4.4.1 for a discussion of the promotion of principles-based accounting over rules-based requirements.
(Bradbury, 2003). This produces what is referred to as the “classic qualitative characteristic trade-off between relevance and reliability” (Bradbury, 2003: 392). For example, Barclays Bank plc (1999 annual report: 142) warned in their annual report that readers are “advised to use caution when using... [the disclosed fair value] data to evaluate the Group’s financial position”.

Despite these criticisms, Gebhardt et al. (2004) ran a three-way simulation model investigating the effects of the accounting rules: firstly, pre IAS 39; secondly, under the reporting rules that governed at the date of the study (IAS 39); and finally, under a full fair value model. The study found that only under the maligned full fair value model would the accounting standards drive the disclosure of the firm’s true economic position. A further comparability complication arises because IAS 39 allows a choice of accounting policy. When a firm has a derivative used for hedging purposes, it can choose to employ hedge accounting (provided the (hedge effectiveness) criteria to treat it as such are met) or treat the derivative as held for trading. This problem is exacerbated because the costs of meeting the hedge accounting criteria are high, particularly the costs of monitoring hedge effectiveness.

A survey in the US, following the release of SFAS 133, found that 25 per cent of companies preferred to mark-to-market their derivatives rather than suffer the cost burdens of hedge accounting, despite the offset potential (Osterland, 2001). General Electric disclosed that it spent $8 million over a two year period to programme a system to monitor hedge effectiveness. However, there are many examples of where there are associated benefits to efficient systems and controls. The €872m and €2bn reported losses suffered by Allied Irish Bank in 2009 and 2010 arose as a result of the rogue trading of derivatives by an employee of Allfirst Financial, due to the failure to implement a portion of the parent company’s risk management software. This story proved that the derivatives buying and selling processes were not electronic from end to end (Gallagher, 2002) and therefore investment in appropriate systems encouraged by accounting standards might ultimately be cost-beneficial.
Practitioners have claimed that derivatives could and probably would be managed so that they expired prior to the accounting year end to reduce volatility, or would be bought and sold in smaller portions which would allow effectiveness rules to be met wherever possible (Louis, 1997; Partnoy, 2002; Fitch Ratings Research, 2004; Kruger, 2005). This triggers conflicts related to reliability, verifiability, comparability and understandability. Due to the asymmetric nature of this information, empirical evidence of this is understandably somewhat limited. Amongst those who have investigated this issue, Sapra (2002) argued that transparency and hedging disclosures do not necessarily ensure prudent risk management practices, and in some cases might even encourage speculation when managers have the opportunity to exploit market expectations.

Geczy et al. (1997) reported that firms might use financial instruments to speculate rather than hedge for two principal reasons: firstly, if firms are close to distress and equity holders view their shares as an option on the levered firm; and secondly, there is the opportunity to benefit from arbitrage opportunities due to economies of scale. In addition, there is the possibility that certain bonus schemes focused on short-term gains and losses might motivate managerial earnings manipulation, which could be achieved via speculation-driven financial instruments usage. The majority of studies have been reluctant to try to identify and separate out when firms use derivatives for speculative purposes (for examples see Berkman and Bradbury, 1996, Berkman et al., 2002). This, of course, weakens the reliability and robustness of the conclusions of studies seeking to test economic rationale against commercial practices. The financial consequences of speculative positions can be linked to future cash flows and thus abnormal volatility, whereas the hedged component of transactions will be set off (modeled by Gigler and Hemmer, 2007).\(^{50}\)

\(^{50}\) Those surveys that have directly asked firms to identify whether derivatives were being used to speculate found that firms stated they were not (see for example Graham and Rogers, 2001).
Sapra (2002) found that greater levels of disclosure do not necessarily equate to an elimination of imprudent risk management strategies, and that, in fact, SFAS 133 might promote speculation. Research shows that firms adopt prudent risk management strategies even when full disclosure is not required, and therefore the need for the extra financial instruments disclosures needs to be ultimately questioned. Sapra’s study (2002: 933) argued that transparency, as opposed to preventing speculation, actually encouraged firms to adopt “excessive speculative positions”. The weakness of Sapra’s (2002) work is the assumption that managers make all decisions to maximise shareholder wealth for current investors, and that investors have access to the full nature and timing of the underlying exposure, which is not always possible for complex cash flow hedges (Gigler and Hemmer, 2007).

Sapra and Shin (2007) found that, dependent upon the quality of market information and the credibility of the company’s hedging disclosures, there was the possibility that due to the new derivatives disclosures regulations, companies might deliberately engage in excessive speculation where otherwise before they would not have. In contrast, Zhang (2009) found that companies that were classified as ineffective hedgers or speculators before the release of SFAS 133 became more effective hedgers post SFAS 133, and thus accounting rules encouraged improved risk management practices. In accounting terms the changes to the reporting of financial instruments had a significant impact, introducing complications arising from a complex mixed-attribute model and from rules-based requirements in a principles-based system. However, the consequences of the introduction and subsequent revisions to the financial instruments reporting standards forced(-es) treasury managers to re-examine their optimal hedging practices.

Greenspan (1997) wrote a letter to the FASB regarding the proposed cash flow hedging criteria,\textsuperscript{51} in which he argued that this accounting method would increase the volatility of comprehensive income. He stated that this would create an unwanted side effect, and rather than encouraging sound and

\textsuperscript{51} During the discussion phases prior to the release of SFAS 119 and SFAS 133.
prudent financial risk management practices would instead have the reverse effect.

Greenspan’s sentiments were echoed amongst practitioners and finance journalists (for instance Osterland, 2000; Osterland, 2001; Michell, 2001; Bodurtha and Thornton, 2002; Fitch Ratings Research, 2002; Di Paola and Cattoor, 2000). Kruger (2005) launched a critical attack on behalf of the UK-based Association of Corporate Treasurers (ACT) when he commented in the trade journal *The Treasurer*, “despite consultations, the International Accountings Standards Board (IASB) has yet to address several common issues [in relation to IAS 39]… There are many situations where there is a disconnect between what the accounts reflect under IAS 39… and the true economic reality. In some circumstances this may even have the impact of hedging policies being changed to sub-optimal structures”. These views were shared by the ACT’s transatlantic equivalent - the Treasury Management Association (TMA). Louis (1997)\(^{52}\) argued that the burden being enforced for lengthy qualitative risk disclosures\(^{53}\) of partial hedges “will only create the perverse result of discouraging hedging activities… and encouraging… unhedged risk profiles” because of inequities between those who need to report and those who do not. Though Louis does not continue this to a financial reporting argument, it seems clear that this would further exacerbate the concerns related to the deterioration in the quality of the financial information and the impediments to the qualitative characteristics.

Louis (1997) further reported survey findings undertaken on behalf of the publication *derivativesstrategy.com* that practitioners found it difficult to fully understand and produce the disclosures. Barton (2001) asserted that SFAS 133 had the potential to reduce hedging and increase earnings management, whilst Papa (2010) argued that SFAS 133 had the potential to persuade firms to increase their use of derivatives even when this usage was inappropriate.

\(^{52}\) Quoting from the TMA.

\(^{53}\) Which were reflected in IAS 32 and subsequently carried forward to IFRS 7.
To summarise, practitioners and academics have agreed that there was (is) the scope, both theoretically and practically, for the financial instruments standards to provide companies with the opportunity to deliberately misuse or abuse their derivatives-based risk management strategies. This could lead to deliberate misrepresentation and/or under-performance.

One would probably expect practitioners to be largely critical of the new reporting standards as they create costs and force the release of previously non-mandated information, thus closing the information asymmetry gap and opportunities for managerial impact. Nevertheless, there have been studies which have found that there was no firm evidence of an intention to deliberately forego sound risk management strategy as a result of these accounting changes (see for example Essaides, 1999). The purpose of this study is not to investigate these risk management approaches, but it is important to be aware that information asymmetry and agency conflicts are important within this area of research, and hence the need for further study.55

2.3 Value relevance: The case for disclosures

2.3.1 Background

It is important to note that the intention of this project is not to rework prior value relevance studies but instead this section serves to highlight that these studies and connected issues exist, and by doing so throw light on the importance of disclosures and, in particular, financial instruments disclosures. Corporate disclosures are arguably most useful when they carry extra information which would be excessively costly to gather from other sources, or when it is simply not available elsewhere. It has recently become fashionable to measure the ‘quality’ of accounting information by analysing earnings. It

54 Discussed later.
55 Also, due to the reporting requirements, whereby positions are recorded at a specific point in time at the year end, these issues would be almost impossible to investigate through an ex-post disclosure review, such as the one adopted in this study, with any credibility. Therefore, this section simply highlights the importance of these issues as they might have a bearing on interview data in Chapter 7.
has been shown that certain factors are important to the quality of discretionary disclosure. Amongst these are: excessive conservatism (e.g. Ball et al., 2000); earnings smoothing (e.g. Leuz, Nanda and Wysocki, 2003); earnings persistence (Dechow and Dichev, 2002); and value-relevance (e.g. Francis and Schipper, 1999). The latter of these issues has been considered in the context of financial instruments reporting specifically and therefore is examined in more detail.

2.3.2 Disclosure value relevance

The value relevance literature is broad; however, only a small number of researchers have considered the value relevance of derivative financial instruments disclosures specifically (of note are Barth, Beaver and Landsman, 1996; Skinner, 1996; Venkatachalam, 1996; Eccher, Ramesh & Thiagarajan, 1996; Seow and Tam, 2002; Wang, Alam and Makar, 2005; Ameer, 2009). In contrast to the conclusions of the non-financial risk disclosure value relevance studies, which have found mixed results, the studies related to financial instruments (with the exception of Mozes, 2002) have found that the disclosures of financial instruments are provided in addition to other price relevant information, and therefore will most likely act to impact on the cost of capital – i.e. it is value relevant. In addition, several studies have noted a further economic consequence of hedging and derivatives disclosures when they found that for certain industries, financial instruments disclosures inform production and pricing decisions (Rajgopal, 1999; Kanodia et al., 2000).

Using Ohlson’s (1995) valuation framework, studies have found (for instance Wang et al., 2005) that derivatives disclosures are value relevant. However, these same studies have also highlighted their own deficiencies. Principally, they have noted that the data they have used has limitations and is constrained because of it being out of date. In other words, it has looked at periods related to pre SFAS 133 (the fore-runner and model for IAS 32 and IAS 39 and subsequently IFRS 7 [see Section 1.2 for more details]) disclosure requirements. In addition, the prior studies have restricted themselves to the

---

56 And mixed results from Malaysia (Ameer, 2009).
financial sector specific where hedging practices might differ, primarily in terms of extent of usage, to those of non-financial firms. These studies also conclude that they have had to ignore any implications arising from speculative positions and assumed that all derivatives held were for hedging purposes. Econometrics issues, such as the assumptions of clean surplus and linearity within the Ohlson framework, also cast doubts over the results of such studies (e.g. Burgstahler and Dicev, 1997; Ashton and Tippett, 1998).

Seow and Tam (2002) undertook a study investigating the usefulness of derivative disclosures, looking at disclosures of financial instruments up until the release of SFAS 119. They found that “except for notional principal amounts [the derivatives related disclosures] are found to contain new information not incorporated in market beta and earnings” (p. 291). Prior work is divided in its approach to this issue of value creation. One group of researchers have sought to establish whether the disclosure is value relevant (for example Wang et al., 2005; Venkatachalam, 1996), whilst another has sought to identify whether this information is useful as risk relevant information (for example McAnally and Wong, 2005; Combes-Thuelin et al., 2006). Needless to say, unravelling one literature from another is difficult when they are intertwined by the question of relevance and value creation (loss). However, the latter group have reported the same conclusions as the former group. They have consistently argued that the risk relevant information could aid reputation risk management (Berman, 2004; Davies, 2004; Koya, 2004; Kramer, 2004), catastrophic risk management (see review by Niehaus, 2002) and build a better brand or corporate image (Hooghiemstra, 2005).

On the whole, it has been concluded that it is possible for a firm to add value through enhanced financial instruments disclosures in both regards – in other words, under an economic rationale model such as that employed by Wang et al. (2005) and under a qualitative psychological, sociological or political model.

57 And then subsequently use speculation as an explanation for mixed, unclear or unwanted results.
58 Although Hooghiemstra was specifically talking about CSR, the reference made was general in terms of disclosure, and as will be discussed later in establishing the theoretical background to this study, impression management and legitimacy theory are also important to disclosure studies – of which this is one.
Linked to the concept of relevance is the issue of the reliability of the information. This concept has been addressed from the perspective of accruals accounting and earnings persistence correlations with share price movements. Richardson et al. (2005), building on the work of Sloan (1996), confirmed that less reliable accruals lead to lower earnings persistence, which investors misinterpret. This relationship is therefore reflected in more mispricing errors. Thus, we might conclude that the quality of the input accounting information is central to analysts’ interpretations of firms’ performance and behaviour, and the more reliable the information then the greater the minimisation of the pricing errors.

However, the reliability measure is based upon the accounting information input being of consistently high quality. This study addresses this issue and asks whether these reliability and relevance conclusions are robust. This study might also prompt researchers to revisit their work and ask whether their findings might have yielded mixed, unexpected, or distorted results because of this initial input issue.

2.4 Economic rationale for adopting an efficient and effective hedging strategy

2.4.1 Background

As explained in Section 2.1, the majority of financial instruments research has taken derivatives as its focus. This is not unsurprising given the scale, scope and complexity of corporate usage of these financial instruments. It is also relevant to this study because many of the requirements of IFRS 7 are directed at the reporting of this sub-group of financial instruments. If, as is often presupposed, derivatives are used by non-financial entities to manage risks and create value, then the disclosure of the associated gains, losses, assets, liabilities, risks and rewards derived therefrom should be clearly

59 And certainly the more controversial requirements (i.e. competition sensitive, fair value, nature of risks faced, etc.) are risk management or derivatives-based disclosures.
reported. However, if this supposition of risk offset is incorrect and hedging strategies do not create value, then the disclosures are more likely to be manipulated. Thus the economic rationale for using derivatives needs to be considered in any discussion of financial instruments.

It is commonly held that companies use derivatives as hedging instruments to facilitate the primary corporate objective: the maximisation of shareholder wealth. This section firstly examines who uses derivatives, before exploring why firms use these instruments, and where evidence is available, why companies do not use them. Where possible, the review provides examples of prior work that substantiates (or disproves) these rationale.

2.4.2 Who uses derivatives?

Guay (1999) argued that the implementation of a successful derivatives-based hedging strategy serves to reduce a company’s risk. In addition, Graham and Rogers (2000) found that companies adopt and employ derivatives-based risk management strategies as part of a risk optimisation programme. Thus, it has been argued that derivatives-based risk management strategies serve to maximise shareholder wealth and create value. A significant area of research has identified that there is the potential for an effective and efficient hedging policy to reduce costs, and these shall be considered below. However, the question that precedes this is: ‘Who uses derivatives?’ and then ‘Who does not?’

Survey data has shown with reasonable consistency that derivatives usage increases dependence on key determinants, including size, leverage, the existence of tax losses, the proportion of shares held by management, and the payout ratio (see for example Berkman and Bradbury, 1996). The two most significant determinants driving derivatives usage for non-financial companies in Australia were found to be size and leverage (Berkman et al., 2002) and this can be broadly seen through similar US and European studies (Bodnar and Gebhardt, 1999; El Masry, 2006). Thus, generally speaking the larger the firm and the higher the level of borrowings then the greater the
chance a company will use derivatives-based risk management strategies. The usage of derivatives decreases with interest coverage and liquidity (initially shown by Berkman and Bradbury, 1996). Thus, these key determinants justify choosing to sample the largest companies on the London Stock Exchange, as these are the most likely financial instruments users.\textsuperscript{60}

Bodnar and Gebhardt (1999) compared results of the Wharton School survey (1995), which considered derivatives usage with a comparison study undertaken in Germany and found that the choice of instrument and the market view of taking a derivatives-based risk management position were both important to the subsequent risk management strategy adopted. Several other comparative studies of hedgers and non-hedgers produced similar results (including Allayanis and Weston, 2001; Nguyen and Faff, 2002; Visvanathan, 1998; Geczy \textit{et al.}, 1997; Mian, 1996; Nance \textit{et al.}, 1993).

The existence of these determinants does not wholly explain why some companies do not use derivatives to manage their risks. The research in this area is limited, unfortunately. Surveys by Bodnar and Gebhardt (1999) and El Masry (2006) both found that the primary reason for not using derivatives-based risk management strategies was that their exposures were not significant enough and could be managed through other means. This rational decision response appears most likely and one would expect this to be the default answer from management. However, it is interesting that both studies found other reasons for non-usage alongside this and found that companies' choices not to use derivatives were driven by both internal and external attitudes and perceptions. Principally, these included public perceptions of the

\textsuperscript{60} As an aside, it is somewhat surprising that in the UK the smaller the entity, the less likely the use of derivatives to hedge risk (Bodnar \textit{et al.}, 1995; Bodnar \textit{et al.}, 1996; Fatemi and Glaum, 2000; El-Masry, 2006) – despite these smaller entities income streams in general being more volatile. In addition to this greater volatility of earnings, it is also more likely that these smaller entities (most of whom I assume are seeking growth and are small not by choice but by default) who do not control their foreign exchange risk or interest rate risk are also the same firms who, due to their size, are not used to the problems of international trade and greater levels of borrowing. The paradox, thus, is that we know from the prior literature that size is the primary determinant of derivatives-usage and yet the larger and more diversified firms are more likely to be able to sustain the losses which could arise from commonly hedged positions, in other words, foreign exchange, commodity and interest rate volatility.
instruments themselves, management capabilities and their knowledge restraints, the costs of establishing and maintaining a derivatives programme, the difficulties in pricing instruments accurately, and finally the financial reporting demands – including significant concerns regarding the disclosure requirements (Bodnar and Gebhardt, 1999; El-Masry, 2006).

It is this latter issue that is most important to this study. If companies are choosing not to use (derivative) financial instruments because of reporting complexity, and yet derivatives-based risk management strategies increase firm value, then the accounting standard setters are promoting dysfunctional behaviour. Amongst other concerns, this study investigates more fully the proposition that derivatives are not employed because of attitudes towards their accounting, and examines this from an external and internal perspective through interviews and survey data.

During the last three decades there have been a number of empirical studies evaluating derivatives usage by non-financial firms (for instance Belk and Glaum, 1990; Bodnar et al., 1995, 1996; Berkman et al., 1997; Grant and Marshall, 1997; Fatemi and Glaum, 2000; Jalilvand et al., 2000; Allayanis and Ofek, 2001; Carter et al., 2006; El-Masry, 2006; Alkeback et al., 2006) and derivatives usage and effects on corporate risk management (Phillips, 1996; Mian, 1996; Khim and Liang, 1997; Grant and Marshall, 1997; Bodnar et al., 1998; Bodnar and Gebhardt, 1999; Ceuster et al., 2000; Joseph, 2000; Dhanani, 2003; El-Masry, 2006; Zhang, 2009). More often than not, these studies have sought to find general patterns and trends by observing large samples, and this weakens their conclusions because of their generality. By generalising over a large population the findings are dependent, amongst other things, upon all firms having the same objectives, similar management capabilities, long-term stakeholders and similar hedging policies and practices. Secondly, with only the rare exception, all work in this area pre-dates SFAS 133, IAS 32, IAS 39 and IFRS 7. By analysing a small sample of firms, more robust conclusions can be drawn and a richer and more in-depth examination of the data can be undertaken.
2.4.3 Hedging and firm value

Modigliani and Miller (1952) originally argued that the balance of funds between debt and equity is irrelevant to the external investor in arriving at firm value. Therefore, any methods to control financial risk are counter-intuitive. One of the methods to control financial risks is hedging, and thus Modigliani and Miller's original theory (MM1) would argue that rather than increasing value, hedging can actually reduce the value of a business.

However, as noted by subsequent commentators (for example Modigliani and Miller, 1961 & 1963; Robichek and Myers, 1966; Baxter, 1967) MM1 ignores taxes, bankruptcy costs, and asymmetric information and assumes perfect information. It has been opposed and challenged, and a number of cost reductions associated with an efficient and effective hedging policy have been noted, namely: lowering tax costs; lowering financial distress costs; lowering contracting costs; and lowering external financing costs.

These cost reduction strategies arising from hedging policy appear to assist with firm value creation, and they are evaluated over the following sections. The purpose of this study is not to prove or disprove these economic rationales but simply to highlight their importance, as they will be used to aid the drawing up of hypotheses in Chapter 6 regarding financial instruments disclosure quality and quantity.

It should first be noted that there is disagreement amongst commentators regarding whether hedging creates firm value. Though the majority of commentators have argued that efficient and effective use of derivatives to hedge does create value, there are those who have argued otherwise. A notable example is Jin and Jorion (2006), who argued that hedging has no effect on firm value. Carter et al. (2006) subsequently criticized Jin and Jorion’s (2006) research on the grounds that the sample selected was skewed towards an industry where hedging strategies are not adopted as a means of assisting value creation, and therefore their results are misleading. Thus Carter et al. chose to investigate airlines where hedging policies are clear and
transparent, particularly in their intention – i.e. to mitigate risks associated with fuel price volatility. They found that certain costs could be lowered, particularly financial distress costs.

2.4.4 Lowering tax costs and lowering financial distress costs

Smith and Stulz (1985) addressed three main concerns: why some firms hedge while others do not; why firms hedge some risks and not others; and why some firms hedge their accounting risk exposure while others hedge their economic value. They argued that a firm’s hedging policy will be designed around the reduction of taxation costs and financial distress costs and sought to prove that costless hedging increases the value of the firm.

This latter point was also strongly supported by Mayers and Smith (1982). Smith and Stulz (1985: 396) also contended that the value of a geared entity equals the value of an ungeared entity “*minus the present value of bankruptcy costs plus the present value of the tax shield from interest payments*”. Therefore, if an effective hedging strategy reduces the level of expected bankruptcy costs and can assist in controlling tax payments, then hedging ultimately will have the desired effect of increasing the value of the firm.

Though there have been studies that have found limited evidence of tax losses being related to the decision to use derivatives, such as that of Marsden and Prevost (2005), the majority of studies have found that there is a positive relationship. Graham and Rogers (2000) found that there were two principal tax incentives to hedge: to increase debt capacity and to reduce the expected tax liabilities. Graham and Rogers (2001) found that the estimated benefit of hedging was 1.1% to firm value, with 0.5% of asset value arising as a result of tax benefits.

Studies by Allayanis and Weston (2001) and Nance *et al.* (1993) also found evidence from their samples of 720 and 169 firms respectively that supported hedging decisions being made to reduce expected tax liabilities. If a firm can employ a hedging strategy that reduces the volatility of the income stream and
thus reduces the probability of financial distress, then the debt capacity increases (Stulz, 1996; Leland, 1998). Nance et al. (1993) also found evidence that supports firms making hedging decisions to lower expected transaction costs (see section below) and to control agency costs.

Allayannis and Weston (2001) estimated that the total hedging premium for their sample was between 3.62% and 5.34% of firm value, and the premium obtained as a result of their fixed-effects regression analysis was 4.87%. They concluded that this could be quantified as 0.5% tax benefit, 0.2% bankruptcy costs saving and 4.32% due to the reduction in underinvestment. Allayannis and Weston (2001) clearly stated however that these estimates are inexact, and a relaxation of their assumptions could see significantly different magnitudes of the hedging premium.

The underinvestment issue can be overcome as hedging allows internal funds to be managed more effectively and the volatility of future cash flows reduced. This allows internal funding resources to be moved around the firm and reduces the risk of rejecting positive net present value (NPV) projects because of a scarcity of internal resources. Evidence has been found (for example Graham and Rogers, 2001 and Geczy et al., 1997) that there is a positive relationship between hedging and the product of the firm’s debt. Tufano (1998) argued that this might create an overinvestment problem if managers have ‘pet projects’ and the control to manage funds towards their undertaking.

Mian (1996) examined a sample of 3,022 firms, of which 771 engaged in derivatives transactions and, of these, 543 disclosed that they used these derivatives expressly for hedging purposes. Contrary to the theoretical reduction in tax liability through hedging, there is only weak evidence that “hedging decisions are motivated by income tax savings strategies” (Mian (1996: 411), supporting the findings of Marsden and Prevost (2005).

Related to the issue of lowering financial distress costs, Stulz stated “the primary goal of risk management is to eliminate the probability of costly lower-
tail outcomes – those that would cause financial distress or make a company unable to carry out its investment strategy” (Stulz, 1996: 23–24). One might argue that investors can bear the risk of transactions themselves through diversification of their own portfolio of investments, as opposed to a company adopting a hedging policy. However, this puts aside the underlying vested interest in the long-run prosperity of the business an investor must have, and thus accentuates the importance of not exposing the business to unnecessary financial distress and other related costs (Pike and Neale, 2006).

One of the few studies that attempts to qualify and quantify the notion that hedging increases firm value was conducted by Carter et al. (2006). Whilst focusing specifically on the Airline Industry, Carter et al. (2006) found that fuel price (cost) and capital investment were positively correlated rather than negatively correlated, and that airline companies face significant distress costs (exhibited by the forced sale of aircraft at less than their fair value, Pulvino, 1998; 1999). Therefore, the capacity to hedge risks in the industry is important because airlines that face high distress costs expose themselves to the threat of selling off assets below their market value, and those that hedge the volatility of fuel costs may be able to gain competitive advantage by acquiring these assets. Investors therefore expect airline firms to hedge to facilitate the acquisition of assets during bad times. In turn, an efficient and effective policy to hedge risk has the potential to lead to reputational advantage (Smith and Stulz, 1985), and a subsequent increase in firm value. However, Carter et al. (2006: 81) caveated their findings with the conclusion that though “firm value is positively correlated with the amount of hedging… [a firm] cannot magically increase value by increasing the amount of fuel hedged”.

2.4.5 Lowering of contracting costs

Jensen and Meckling (1976) discussed the risk-return conflict between providers of equity and debt finance. Mayers and Smith (1987) focused on this conflict and found that hedging reduces the probability of not meeting the providers of finance required returns, and thereby reduces contracting costs.
accordingly. Thus, Mayers and Smith (1987) concluded that the lowering of contracting costs was an advantage of an effective hedging strategy.

Other commentators have also addressed this conflict and linked firm value with risk reduction. An example is Myers (1977), who extended the conclusions of Jensen and Meckling (1976) by examining an underinvestment problem. This scenario suggested that shareholders might reject a project if they perceived a sufficiently large portion of the Net Present Value (NPV) return going to the bondholders. The debt providers then factor this into their requirements and raise their return to account for this variability in investment risk. Shareholders therefore might accept more projects if they perceive that this variability of earnings is reduced, for instance by hedging. It might also be a conclusion therefore that providers of debt finance could forego the extra contractual discussions associated with this underinvestment issue and thus reduce contracting costs.

However, contrary to this, studies by Smith and Watts (1992) and Barclay and Smith (1995) contended that contracting costs are only significantly reduced within industries which are less regulated. In the current regulatory climate, where large companies are more likely to use derivatives (Bodnar et al., 1998; Bodnar and Gebhardt, 1999; El Masry, 2006), corporate governance is relatively strong and more strictly enforced. It might be possible to extend these conclusions and suggest that the cost reduction incentive hypothesis loses theoretical authority as time passes and regulation becomes stricter still.

2.4.6 Lowering of external financing costs

It has also been proposed that another measurable benefit arising from an effective hedging policy is the lowering of external financing costs associated with capital market imperfections (Froot, Scharfstein and Stein, 1993). Geczy et al. (1997) and Graham and Rogers (2002) reported that the reduction in variability of cash flows is of prime importance to a business. The underlying purpose of this reduction in variability is that it allows a firm to more readily
raise additional funds to invest in new projects to generate shareholder wealth.

It has been difficult to conclude that external financing costs are reduced in practice, based on the empirical evidence (Mian, 1996). However, it is difficult to imagine that the attitudes of lenders would not be swayed by evidence of an effective hedging strategy versus one of derivatives used for speculation purposes.

2.4.7 Summary

Ultimately when firms hedge transactions they do so to manage risk and reduce the variability in earnings (see for example Geczy et al., 1997), and thus hedging activity is prevalent as a key element of a managerial risk aversion strategy (see for example Smith and Stulz, 1985; Pike and Neale, 2006). However, the goal of the organisation is to maximise shareholder wealth, and therefore investors must believe that an effective hedging strategy creates value or else the management would be penalised via the stock price. Attitudes to hedging amongst investors are not at issue in this project, but the perceptions from management of investors’ reactions are important. With the increased time and cost burden of implementing the hedge accounting rules required by the new accounting standards (Osterland, 2001), firms must believe strongly that a hedging strategy is something desirable to investors if they are going to disclose one.

2.5 Why do firms not use derivatives-based risk management strategies?

There is a small body of literature (Mian, 1996; Khim and Liang, 1997; Grant and Marshall, 1997; Bodnar et al., 1998; Bodnar and Gebhardt, 1999; Dhanani, 2003; El-Masry, 2006) that has sought to identify why firms do not employ hedging strategies despite the arguments made related to the economic benefits that arise therefrom. Researchers have found that larger firms engage in more hedging activity and disclose more information than smaller firms (Bodnar et al., 1998; Bodnar and Gebhardt, 1999). This finding
implies that there are economies of scale restricting or encouraging firms to hedge using derivatives. However, the greater the use of derivatives and the more investors taking an interest in the firm, then the more important the issue of disclosure management becomes.\textsuperscript{61}

When companies have been surveyed as to why they do not use derivatives, the results are particularly interesting (El-Masry, 2006). El-Masry found that 31% of respondents indicated a high concern that they had a lack of knowledge of derivatives and therefore did not use them, 13% moderate concern and 50% low concern. Anderson \textit{et al.} (2004) found evidence that ineffective hedgers tend to increase future use of foreign exchange derivatives, and that there is therefore a growing market for using derivatives as hedging instruments and managing income volatility.

In addition, El-Masry (2006) highlighted a surprising number of respondents that indicated concerns over the disclosure requirements, where 19% showed a high concern, 38% a moderate concern, and 43% low concern (0% stated they had “no concern” related to disclosure requirements). The study did not discuss whether this concern was related to an inability to meet disclosure requirements or rather whether the disclosure requirements might jeopardise their position somehow.

Bodnar and Gebhardt (1999) revealed similar findings. The primary reason for non-usage of derivatives noted by firms in the study was that they were simply not required, i.e. exposures were not large enough, thus making the transaction uneconomic. Firms also stated that they managed their risks through other means (such as netting or operational strategies). Amongst other responses were the public perception of derivatives usage, a lack of knowledge within the firm to engage in derivative usage, and concerns about disclosure.

\textsuperscript{61} Thus helping to justify the sample selected for this project.
Prior research has found there might be a counter argument that derivatives are not used by firms because they are pre-empting that investors cannot interpret the results accurately (for example Gigler and Hemmer, 2007; Hagelin and Pramborg, 2005). Hagelin and Pramborg (2005) found that abnormal volatility was positively correlated with currency derivatives hedging, but not significantly correlated with foreign denominated debt, and thus there is a misunderstanding of the nature and purpose of the derivatives on firm performance. In contrast, Shin (2006) argued that if the reported results cannot be trusted, then management might deliberately choose to sub optimise their hedging strategies or simply not disclose their hedging activities as such.

The worrying conclusion is that it would seem that firms do not engage with derivatives-based risk management strategies where they are suitable, either because they do not have the technical capabilities to initiate a derivative-based risk management programme, or because they are nervous about disclosing their positions. As with the FASB in the US, the IASB has released standards that ensure quantitative and qualitative disclosures of derivatives, hedging policies, notional principal amounts, credit exposures and fair values and this much stricter position might well further exacerbate both the lack of knowledge issues and the inability to meet disclosure requirements – and thus might have the effect of reducing derivatives usage, particularly amongst smaller firms.

2.6 Theoretical underpinnings

2.6.1 Background

The quantity and quality of disclosures between one firm and another is variable. Whether quantity can be used as a proxy for quality is a discussion that will be presented in Chapter 6. The concern of this section is to identify the possible theoretical framework(s) that underpin(s) why the disclosures, and in particular the disclosures of financial instruments, might differ.
Verrecchia (2001) argued that the reduction of the information asymmetry gap might be the gateway to a clearer understanding of disclosure practices and strategies. Within this context several other theories have developed. These theories will be explored over the next few sections, and include: impression management (see for example Leary and Kowalski, 1990; Bolino et al., 2008); agency and political costs (see for example Watts and Zimmerman, 1978, 1990; Milne, 2002); signalling (see for example Ross, 1977); legitimacy (see for example Carpenter and Feroz, 1992, 2001; Chalmers and Godfrey, 2004; Tilling and Tilt, 2010); proprietary costs (see for example Verrecchia, 1983; Dye, 1985, 1986, 1990; Darrough and Stoughton, 1990; Wagenhofer, 1990); and contingency theory (see for example Doupnik and Salter, 1995; Lopes and Rodrigues, 1997).

It is likely that, of those listed above, certain theoretical explanations carry greater weight than others for this study, principally as a result of the nature and size of the sample of companies selected. As a result of the high quality accounting and auditing standards and the associated assumption that there will be a high level of audit quality amongst the Big Four, alongside other factors such as the large number of sophisticated analysts following these entities, the high levels of corporate governance for these large listed entities in the UK (Brown and Tarca, 2005; Leuz, 2010),\(^{62}\) the role of Non-Executive Directors (NEDs) and the greater ability to enforce compliance with accounting standards in the UK, mean that impression management, legitimacy theory and proprietary costs theory are probably the most relevant. However, the other theories are introduced here and explored in greater detail where those theories which have been identified as most likely to adequately explain a practice, behaviour or strategy appropriately or fully fail to do so.

\(^{62}\) From an accounting perspective (e.g. Leuz, 2010; Brown and Tarca, 2005) there have been investigations into the adoption of IFRS and compliance with Standards. There is no single accepted measure for the relative strength or quality of governance systems. However, a series of papers providing evidence of the varying levels of governance were published by La Porta et al. (1998, 1999, 2002), and Kaufmann, Kraay and Mastruzzi have collected data related to Worldwide Governance Indicators (WGI) (also referred to by La Porta et al.), all of which show the UK to have relatively high governance compared to other nations. The robustness of the measure has been challenged (notably Spamann, 2006, 2008) but regardless, the results remain consistent. The latest WGI Rule of Law results (2009) indicate that the UK is in 15\(^{th}\) place (out of 213 countries) in terms of strength of corporate governance systems and their proper application.
Most theories of corporate disclosure strategies conclude that, provided the information is credible, disclosures will be made if it is feasible to do so (Dye, 1986). These mandatory disclosures are made due to the benefits of a reduction of information asymmetry and an associated reduction in the cost of capital (Botosan, 1997; 2006). However, some of these disclosures might be promoted, marginalised, or omitted depending on the value placed on them by real or financial externalities (Dye, 1990), and the associated costs (financial and non-financial) of making these disclosures. More recently, disclosure studies have highlighted other significant factors contributing to withholding information, including board composition (Karamonou and Vafeas, 2005), the proportion of shares held by management (Guo et al., 2004), managerial incentives (Ajinkya et al., 2005), competitive cost advantage (Bhojraj et al., 2004), and legal costs (Johnston et al., 2004). However, under a mandatory disclosure regime many of these issues and costs become less relevant, as all companies are forced to disclose the same information, provided there is a strict enforcement of the regulation – as there is believed to be in the UK.

2.6.2 The objectives of disclosure and the role of theory in providing a coherent explanation for increased (reduced) disclosures

Voluntary disclosure research has become increasingly more fashionable. There are several reasons why this might be the case, including: firstly, the increased quantity and quality\(^{63}\) of voluntarily disclosed information; secondly, the accessibility for non-technical researchers to this information, as it is largely discursive in nature and understandable to those without detailed knowledge of financial reporting requirements; and, thirdly, the information content demanded by users of the annual report and financial statements for example analysts, ethical investment trust advisors, capital providers and environmental pressure groups. It is worth remembering however that, for the main part, this information is unaudited, despite being in the annual report,

\(^{63}\)Although, definitions related to the quality of this information are of course difficult to ascertain.
and there are also doubts about whether analysts and investors use\textsuperscript{64} this information (Campbell and Slack, 2007), and when they do, if it has any economic consequences\textsuperscript{65} (Aerts and Cormier, 2009).

Despite these negative observations, it has been argued that there are benefits associated with making voluntary disclosures. These gains are typically associated with reputational capital improvements (see for example Bebbington, Larrinaga and Moneva, 2008a; Polonsky and Jevons, 2006) and cost of capital advantages, especially when the disclosures are of a particularly high calibre (Botosan, 1997, 2006; Abraham and Cox, 2007; Armitage and Marston, 2008).

Thus, when disclosures become mandatory and yet companies do not comply with the requirements, it is necessary to ask why this might be the case. One would assume that where a disclosure is required (rather than being voluntary) any reputational capital adjustment for non-compliance would be severe, as would any movement in the cost of capital. As discussed earlier, corporate disclosure practices are motivated both by internally driven corporate communication objectives and by external pressures and stimuli. In a perfect world, managers should initially focus on providing useful decision-making information to external users. However, there are checks and balances in place that might affect the nature and content of the information disclosed.

It is possible to summarise the external motivations into two major sub-categories: firstly, to provide useful information for investors and other stakeholders; and secondly, to meet minimum disclosure requirements to ensure a clean audit report. In a mandatory reporting environment such as the reporting of financial instruments, with the assumption that the requisite information must be disclosed, the internal motivation becomes to ensure that

\begin{footnotesize}
\textsuperscript{64} For the reasons stated this might be resultant from trust and credibility issues.
\textsuperscript{65} It seems from Aerts’ and Cormier’s work that it is easier to measure the environmental information’s economic impact in the US than in Europe, and specifically in the UK.
\end{footnotesize}
the disclosures being made either add value or minimise losses, whether these be of a financial or non-financial nature.

Therefore it can be seen that there are underlying presumptions from the field of voluntary disclosure research related to the decision of whether to make the disclosure or not. It is argued that full disclosure is dependent upon issues such as the trends, the causes and the effects of good news versus bad news. In a mandatory setting these become less relevant. Where disclosure has been mandated - as is the case with financial instruments and financial risk management disclosures - the question of whether to disclose carries (the potential for far) more onerous consequences. A company that deliberately chooses not to comply with mandatory disclosure requirements risks significantly higher potential penalties.66 The information choice changes from the simple include/exclude to a more complex: exclude with more severe penalties; include in its entirety; include in its entirety but with bias; comply in full but with information that lacks meaningfulness because of the looseness of the requirement.67

Through the next few sections, the theoretical underpinnings associated with the various external and internal motivations as drivers for full disclosure are briefly examined and explored. In the discussion Chapters 4–7 these theories will be tested and assessed, on the balance of most likely outcomes, whether they serve to explain the financial instruments disclosures or whether the motivations lie elsewhere, and extant theory is not enough.

2.6.3 The case for full compliance: Audit quality and litigation costs

It is often argued that as the reputation of an auditor increases (often proxied by Big Four / non-Big Four) then a more reputable firm can charge higher

66 Although the Financial Reporting Review Panel (the UK body responsible for enforcement of accounting standards) tends to look favourably upon companies who choose to amend accounts once asked, and not impose large fines, there are hidden costs, such as reputational capital costs and increased investor risk perceptions.

67 Please refer back to section 1.5 which includes a brief discussion of the possibility of information usefulness issues being triggered by poorly designed requirements as a result of either looseness or over-specificity.
fees, gain greater market share, attract the best staff and so forth (Craswell et al., 1995). In addition, due to the potential litigation costs and reputational damage for auditors for failing to report non-compliance with disclosure requirements, one is forced to ask why there is any non-compliance with the relevant set of standards requirements.

In the context of this study the existence of non-compliance should be minimal, as the entire sample being considered are audited by the elite firms, i.e. the Big Four (Francis, 2004). Both audit researchers and professional commentators have long held that the auditing profession has a top tier who can charge a premium for their work because of the associated audit quality (McMeeking et al., 2006) and the reputational capital held (Francis and Wang, 2008). The greater assurance from Big Four work and the associated premium is usually attributed to either greater effort (more hours billed) or greater expertise (higher charge-out rates). The determinants of disclosure studies tend to support this argument and thus this implies that smaller audit firms will probably have lower audit quality levels and higher non-compliance issues. We might therefore assume that the compliance levels for companies in this study will be at the top end of results across the total population of companies reporting under IFRS 7.

The point was made earlier but it is worth reiterating here. The costs to the auditors themselves of waving through non-compliance or failing to ensure full compliance with mandatory reporting requirements are potentially extremely high. Thus, unless there are serious breaches in the auditor-client relationship, then the overall costs outweigh any potential benefits. In this light, it would seem that non-compliance will be preparer-driven rather than audit-driven. Therefore it is important to consider other explanations for any failures to meet (or exceed) a reporting standard’s requirements.

---

68 Obviously in this case the Big Four although this sometimes in accounting and audit research becomes the Big Four, Five or Six (dependent upon the date of the study) + 2 (i.e. Grant Thornton and BDO in the UK context).
2.6.4 The proprietary costs theory

At first glance it might appear an intuitively sound assumption that companies will provide full and complete mandatory annual report disclosure to meet the demands placed upon them by stakeholders and ultimately the accounting standards setters. Thus, it is not unreasonable to expect that there should be zero breaches in mandatory disclosure requirements given the standard setting due process, and the potential repercussions of being discovered to be non-compliant. However, many prior studies have not found this to be the case. One possible reason underlying these discrepancies is provided to us by Proprietary Costs Theory (Dye, 1985).

Proprietary Costs Theory (Verrecchia, 1983, 1990; Wagenhofer, 1990) states that there is the potential for companies to not participate in a full disclosure strategy because of the existence of disclosure related costs, or in other words, proprietary costs. These proprietary costs exist because there are the initial costs of preparation, then the costs of dissemination, but then most importantly there are also the costs of disclosing the information. There are many possible causes for this latter category of costs to arise. Amongst these might be that the information being disclosed is deemed damaging from a competition standpoint or because there may be some reputational capital damage incumbent in the news.69

Unfortunately there is only a limited amount of prior work that has sought to investigate mandatory disclosure informational effects. Gigler and Hemmler (1998) concluded that mandatory disclosures play a mainly confirmatory role for investors, whilst Dye (1985; 1986; and 1990) reviewed mandatory disclosure from the perspective of whether there was the potential for a negative impact on existing information once disclosure became mandated. Dye (1985) argued that there was the risk that when disclosure became mandatory through accounting-led change, useful information might be lost.

69 It should be noted that it has been argued that investors’ reactions to the withholding of proprietary information are negatively correlated with the increase in the proprietary cost of the disclosure (Verrecchia, 1983).
Thus, there is a risk that by mandating disclosures the standard setters might encourage less useful information to be provided.

Dye (1986) subsequently challenged the argument that full disclosure was always optimal when information was credible and costless, and found that this does not always hold. He found that there are occasions, principally for proprietary disclosures, when non-disclosure or partial disclosure might be made. Dye (1986) also found that by making certain disclosures mandatory, there could be a greater incentive to disclose more information voluntarily. Darrough and Stoughton (1990) analysed the incentives for voluntary disclosures of proprietary information. They found that when the prior of the market is pessimistic and there are high entry costs, then it is most likely that disclosure will be either incomplete or non-existent.

2.6.5 Legitimacy theory, reputation risk management and impression management

2.6.5.1 Introduction

Vanstraelen et al. (2003) argued that, where voluntary disclosures are permitted, larger companies and companies with a global perspective provide higher levels of disclosures. In turn, this increased disclosure allows a more accurate future earnings forecasting process to take place. However, despite this conclusion, there is evidence to suggest that mandatory disclosures make it more difficult for firms to voluntarily release credible information which they might otherwise have previously disclosed (Akerlof, 1970; Teoh and Hwang, 1991). The explanations for the release of voluntary information are varied; however, what is clear is that extra information is not costless and might lack both feasibility and credibility in some instances.

DeMarzo and Duffie (1995) studied hedging disclosures and concluded that bottom line profits are a key indicator of management talent. They found that hedging reduces the noise from the information available and therefore makes current and future earnings more transparent. Later studies, such as
Reynolds-Moehrle (2005), have also found similar results. From a different perspective, Koonce et al. (2005) found that potential investors\textsuperscript{70} were positively influenced by certain terminology. They identified that users' perceptions of upside and downside risk can be manipulated when certain phraseology is used. When the phrase “used as a hedge” is introduced, users perceived less risk. Koonce et al. also found that users functioned through a simple mechanism referred to by Tversky and Kahneman (1973) as ‘availability’, whereby perceptions of risk changed where there was connectivity between past results and propositions.

This might go some way to explain Allayanis and Weston’s (2001) conclusions when they found that when firms begin a hedging strategy the value of the firm increases, and when firms cease with their hedging strategy there is a decrease in the value of the firm relative to firms who remain hedged. The literature shows that when management adopt and disclose an efficient and effective hedging strategy, then they portray themselves as undertaking a strategy that deliberately reduces the risks of the entity (and thus reducing beta and thereby increasing firm value). Reynolds-Moehrle (2005) argued that managers might announce the adoption of a risk management strategy to highlight that transitory shocks are beyond their control.

DeMarzo and Duffie (1995) highlighted that this relationship is not quite so straightforward. They showed that investors did not simply believe that hedging increases firm value but also that investors saw an efficient hedging policy as a way of reducing profitability (thus reducing the value of the firm). This is an example of the contrast between maximising profit and maximising shareholder wealth. Watts and Zimmerman (1978; 1990) found similar results to DeMarzo and Duffie and they argued, along with others subsequently (Milne and Patten, 2002; Milne, 2002; Patten, 1991, 1992; Deegan and Gordon, 1996; Panchapakesan and McKinnon, 1992), that managers made certain disclosures because it was in their interests to do so.

\textsuperscript{70} In this case the sample was MBA students as a proxy for investors and one might query the appropriateness of this group as a suitable sample.
A stream of literature has recently emerged in the field of finance, led by Tetlock (2007; 2010; Tetlock, Saar-Tsechansky and Macskassy, 2008), which has sought to quantify language in value terms. Though findings are mixed, related to the direct significance of language to ease or overcome the information asymmetry problem, the findings in relation to fundamentals information are important to this study. This literature finds that where news items include negative words in relation to information about firm fundamentals, then the greater the predictability of the earnings and returns. In addition, it has been evidenced that the market underreacts to the information embedded in negative words.

Thus, in the area of financial instruments, and in particular financial instruments-based risk management strategies, where the information has been shown to be value relevant, one can make the logical bridging assumption that language is potentially worth investigating. Therefore, the next few sections consider the sociological and psychological implications of information on stakeholders’ interpretations.

2.6.5.2 Legitimacy theory and reputation risk management

Legitimacy is defined by Suchman (1995: 574) as “a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions”. This definition unravels into two separate strands: institutional legitimacy and organisational legitimacy (Tilling and Tilt, 2010). Due to a combination of factors including the relative size, nature and level of institutional ownership of firms featured in accounting studies, many commentators have deemed institutional legitimacy – “how organisational structures as a whole… have gained acceptance by society at large” (Tilling and Tilt, 2010: 57) – as considerably less relevant as an underpinning theoretical explanation for disclosure practices. Organisational legitimacy however has been the focus of attention, given that it refers to the concept that organisations attempt to ensure there is an apparent symmetry between
the social values, strategies and operations of the company and the “social norms of acceptable behaviour in the larger social system or environment they are part of” (Dowling and Pfeffer, 1975: 122). Financial instruments disclosures are particularly relevant in this context given the information asymmetry often associated with derivatives positions and financial performance. It is thus often necessary for companies to justify legitimate derivatives usage, practices, policies and management to shareholders and other user groups.

Organisational legitimacy studies have focused on specific areas of financial reporting and, more recently, they have placed greater emphasis on the social and environmental reporting practices, claiming to have found evidence of legitimisation strategies and practices (Li et al., 1997; Brown and Deegan, 1998; Deegan et al., 2000; Bewley and Li, 2000; Patten, 1991, 1992; Milne and Patten, 2002; Clarkson et al., 2008; Branco and Rodrigues, 2008; Bebbington et al., 2008; Aerts and Cormier, 2009). There have also been a handful of investigations into the theoretical rationale underlying financial instruments disclosures, and these studies have occasionally found limited evidence supporting legitimacy theory (Chalmers, 2001; Chalmers and Godfrey, 2004; Lopes and Rodrigues, 2007).

Reputation is conceptualised by economists as an intangible asset with the potential for value creation, and by sociologists as the outcome of shared socially constructed impressions of a firm (Dierickx and Cool, 1989; Barney, 1991; Fombrun and Van Riel, 1997; Scott and Walsham, 2005). Reputations are one of the key foundations of companies’ actions, and firm value is structured upon assessments and management of those actions (Schweizer and Wijnberg, 1999). A hierarchy of reputation is created and reputation risk is the extent to which any one aspect of reputation may be lost by an organisation (Fombrun and Van Riel, 1997; Fombrun et al. 2000; Chalmers and Godfrey, 2004). Within this school of thought, firms voluntarily disclose financial reporting information to manage reputation risk as part of their overall risk management strategy.
Reputation risk management is occasionally cited as the theoretical underpinning to explain disclosure practices and policies (Polonsky and Jevons, 2006). Studies in this area can be criticised for the inherent problems associated with the conceptualisation, characterisation and measurement of reputation risk (Deephouse, 2000). Deephouse and Carter (2005) argued that a focus on isomorphism leads to improvements in organisational legitimacy, but its effects on reputation depend on the entity’s (in the case of this study, bank’s) reputation.

In addition prior studies have failed to identify whether reporting practices being employed were intended as legitimation devices or impression management strategies (for example Hoogheimstra, 2000), and at the heart of this problem is a failure to investigate the “broader context… or the realities of organizational processes and their participants” (Adams, 2008: 367).

Reputation is complex in nature and is often both specific to a particular organisation and dependent on historical events that are difficult to untangle ex-post (Barney, 1986; Dowling, 2001; Dierickx and Cool, 1989). A recent review of the extant corporate reputation literature concluded that reputation, in the context of corporate practices, lacks a comprehensive and accepted definition (Walker, 2010). Another conceptual difficulty associated with this strand of literature is the problem associated with isolating reputation risk management from the management of other organisational processes (Fombrun and Van Riel, 1997; Hutton et al., 2001). Although there is clear evidence of reputational risk management in voluntary disclosure (e.g. the example of Shell examined by Hoogheimstra, 2000 and cited by Bebbington et al., 2008), prior studies are scant (Shenkar and Yuchtman-Yaar, 1997; de Castro et al., 2006). In addition, as Adams (2008: 368) stated in the discussion of Bebbington et al. (2008), “Should we rename legitimacy theory reputation theory? Would that solve the problem?”

Regardless of the difficulties associated with identifying and disaggregating instances of legitimisation or reputation risk management, it is perfectly rational and intuitively sound to suggest that management often face an
agency conflict between information they wish to disclose and information that is obligatorily disclosed\(^7\) (a detailed review of the agency conflict effect on information provision has been undertaken by Lambert, 2001\(^2\)). One can achieve this through a number of strategies but principally via obfuscation, omittance or manipulation of information. It is possible to conclude therefore that in a mandatory reporting environment, agency and political costs, and the associated theories, become closely correlated with impression management and legitimacy theory.

Professional commentators have considered non-compliance to be associated solely with a will to mislead and deceive investors regarding value – or in other words, manipulation of information pegged to an economic motive (Partnoy, 2002; Fitch Ratings Research, 2004). However CSR disclosure studies have allowed researchers to reconsider these conclusions through a different lens. These studies have made it impossible to overlook the sociological and psychological signals associated with disclosure management, particularly from an impression management and legitimisation angle. This is especially true when one views the annual report as part of a corporate communication strategy, rather than simply the traditional report on position and performance it might have been in years gone by.

It should be noted however that there is a conflict between disclosure creating reputational gains but delivering other associated costs or problems. Although researchers have found that reputational gains are strongly associated with robust and transparent non-financial disclosure, to counteract the managerial will to disclose more of this information, there is an associated negative correlation between institutional ownership and disclosure (Abraham and Cox, 2007). This conclusion suggests that investors prefer less risk-relevant disclosure, and the reputational gains are offset by less institutional investment for the disclosing firm (Milne and Chan, 1999). Bushee and Noe (2000) found that yearly improvements in disclosure rankings attract more

\(^7\) This is further exacerbated when management are called upon to disclose information they would rather not, i.e. bad news.
\(^2\) See in particular Chapters 4 & 5.
transient, short-termist, institutional investors, who are generally characterised by aggressive trading. In addition, Rogers and Buskirk (2008) found that the amount of information disclosed decreases after litigation.

2.6.5.3 Impression management

A second school of thought argues that firms produce voluntary disclosures as part of an impression management strategy (for a summary see Beattie et al., 2008). A number of theories from the behavioural finance and psychology literatures have been used to explain why investors might be susceptible to managerial led impression management. Drawing on the work of Schlenker (1980), it is possible to define impression management in this context as the voluntary disclosure of information by firms to protect their self-images and/or influence the way they are perceived by significant others. Companies voluntarily disclose information to mitigate against the potential for adverse selection that would arise from non-, or a lack of, disclosure (Grossman, 1981; Milgrom, 1981). Voluntary disclosure is assumed to be consistent with impression management if the market is aware of the existence of bad news (Verrecchia, 2001). Impression management research examines the strategies employed (Buss et al., 1987), motivation (Arkin et al., 1980), characteristics related to the use of impression management (Baumeister and Jones, 1978; Schlenker and Leary, 1982a), and reactions to impression management (Schlenker & Leary, 1982b).

Turning to financial instruments and financial risk management specifically, then it is possible to suggest from the available empirical evidence, and examinations thereof, that sub-optimal hedging strategies have historically been employed. Jorgensen (1997), for example, showed that sub-optimal hedging strategies have been employed where mark-to-market hedge accounting has been adopted. A further study conducted by Melumad et al. (1999) divided up the objectives of potential and current shareholders, further separated investors between short-term and long-term shareholders, and identified that within these divisions there were varying optimal positions and differing preferences over hedge accounting methods. Furthermore, Smith
and Stulz (1985) looked at this issue from the perspective of management and argued that management will most likely over- or under-hedge, dependent on the function of utility versus year end firm value.

In addition, a number of empirical studies (most recently El Masry, 2006) have strongly linked the level of hedging financial risks to the level of managerial ownership. Nance et al. (1993) argued that if the firm is owned by investors who are not well diversified then there will be a greater incentive to manage risk and therefore for the firm to hedge. Some recent research into management behaviour has suggested that the likelihood of the occurrence of misrepresentation increases where the incentive not to misrepresent is not great enough (Subrahmanyam, 2005).

Given these conflicting arguments, the most persuasive conclusion would be that managerialism or agency conflicts probably play a role in disclosure management strategies. The manipulation of public perceptions of risk and the associated processes, and management of these risks, can lead to gains – even if these are short-term in nature. As suggested by Adams (2008), the large scale samples taken in prior research might not be an appropriate design to be able to identify and capture instances of varying disclosure strategies. Adams’ argument is persuasive and therefore a (relatively) small sample of companies has been chosen for investigation and an attempt to identify instances of non-, partial, full and over-compliance undertaken. Alongside this, the question being asked is whether there is any evidence of a disclosure strategy, or whether specific compliance instances are caused by something more straightforward, for example an auditing oversight.

Subrahmanyam (2005: 20) stated that where managers are successful in “obfuscating value” then investors will find it prohibitively costly to investigate the issue further. This is reinforced by the finding that the cognitive ability required of management to run an organisation is high. In addition, Bhamornsiri and Schroeder (2004: 679) proposed that one of the possible explanations for poor financial instruments disclosures is “a desire to conceal potentially unfavourable information”. This has a dual complication for the
researcher: first, it makes the obfuscation difficult to detect because of the high cognitive abilities of multinational companies’ management teams; and second, this same high cognitive ability makes it more likely that managers will misrepresent performance where there is a perceived gain to be made. Only by examining the evidence closely and in context is it possible to identify potential problems.

In the context of risk disclosures more broadly, Combes-Thuelin et al. (2006) found that there were significant weaknesses in the disclosures. The study suggested that where disclosures are voluntary and the risk of disclosure outweighs the potential return from making that disclosure, then the disclosure ultimately will not be made. Some studies (such as Jovanovic, 1982) have shown that a full disclosure equilibrium strategy exists, whilst others have agreed with Suijs (2005: 1,432) that the incentive to disclose bad news “may arise if the firm faces a fixed disclosure cost and a variable proprietary cost that is relatively large compared to this fixed disclosure cost”. In direct contrast to the corporate media message of a reporting conscience, Combes-Thuelin et al. (2006: 303) commented that “managers have been seen to omit information allowing third parties to modify their understanding both of risks and the accuracy of the suggested profitability”.

Prior work has tended to attempt to isolate instances of impression management behaviour by investigating the use of imagery, graphics, photographs, rhetoric and other linguistic or presentational techniques within the annual report (see reviews by Beattie and Jones, 2008; Beattie et al., 2008; Davison, 2008) and through press releases (Allee et al., 2007). These predominantly qualitative studies have agreed that the users’ perceptions are being borne in mind when the information is produced, and particularly in the way the information is presented.

Whilst looking at firms’ voluntary disclosures there are a number of commentators who have argued that there is evidence of a storytelling agenda (Boje et al., 2006). It is thought that systematic disclosures that attempt to guide perceptions likely contribute towards building a better brand
image (Phillips, 1996; Hooghiemstra, 2000), and sometimes towards managerial ‘empire building’ (Hope and Thomas, 2008). Thus, storytelling and impression management are closely linked. In addition, it is thought that disclosure policy can be correlated to risk reduction, and thus a reduction in the cost of capital (see for example Botosan, 1997, 2006; Abraham and Cox, 2007; Linsley and Shrives, 2000), which would further lend sway to the argument that managers are keen to disclose effective risk management strategy information under self-interested motivations.

Therefore, achieving a high disclosure index score in a voluntary disclosure environment might create unrealisable gains if the disclosure has been managed. A recent report by Salter Baxter (2008), a corporate social responsibility consultancy, into CSR practices by major listed entities, found that some of Europe’s (arguably) most criticised companies in the field of CSR, such as Nestlé and British American Tobacco, are amongst the front-runners in terms of the quality of their CSR reporting. Of course, as with all voluntary disclosure indexes, quality is a subjective matter defined by the party writing the index and undertaking the study. These findings have not been supported by academic studies – for example Campbell, Craven and Shrives (2002) found that sinful\(^\text{73}\) companies do not disclose more social information than non-sinful firms.

Gray et al. (1995) found that the direct impact on share price of greater voluntary non-financial information was negligible. However they noted that there might be follow through gains of the extra disclosure by virtue of social accountability. This has become a popular argument (for example see Rippington and Taffler, 1995); especially with the recent focus on the environmental, ethical and social disclosure (Gray and Bebbington, 2001). These studies have concluded that CSR reporting can almost entirely\(^\text{74}\) be set within the construct of reputation risk management (Bebbington, Larrinaga and Moneva, 2008; Polonsky and Jevons, 2006).

\(\text{\textsuperscript{73}}\) Tobacco and brewery

\(\text{\textsuperscript{74}}\) Marston (2008) has recently evidenced that firms’ cost of capital is associated with CSR. Where firms fall below good practice levels then the cost of capital increases significantly, whilst best practice produces negligible decreases in the cost of capital.
2.6.5.4 A comparison between legitimacy theory and impression management
and the potential impact of these disclosure theories

It appears that the key distinguishing characteristic of these two schools of
thought – legitimacy and impression management – is the intention and
direction of the management of information. Voluntary disclosures in a
legitimacy theory framework can be seen as organisations voluntarily
disclosing information to justify the company's activities, to conform to social
norms and/or to manage what stakeholders are expecting to read. This often
involves the legitimisation of specific transactions and business decisions. By
contrast, voluntary disclosure in an impression management framework is the
disclosure of information to create a general impression of the firm and offset
any potential bad news. Impression management studies can be criticised for
focussing on external audiences and public behaviour. However, maybe this
is justifiable when one considers the underlying purpose of impression
management. Prior literature, both theoretical and empirical (e.g. Schlenker,
1980; Leary and Kowalski, 1990) have shown that impression management
stems from an initial position whereby the information is intended to
deliberately affect or manipulate the impression which the information might
have caused, given no discussion, or limited or complete disclosure. In
contrast, legitimacy theory looks to, as the name suggests, legitimise (usually
underperforming or unusual) operations, actions or events.

Contrary to these findings, prior work has identified a problem with these
disclosures. The reputational gains created seem to be accompanied by
associated penalties or problems. There is an associated negative correlation
between institutional ownership and disclosure (Abraham and Cox, 2007).
This conclusion suggests that investors prefer less risk relevant disclosure,
and the reputational gains are offset by less institutional investment for the
disclosing firm (Milne and Chan, 1999). In addition, Bushee and Noe (2000)
found that yearly improvements in disclosure rankings attract more transient,
short-termist, institutional investors who are generally characterised by
aggressive trading. In addition, Rogers and Buskirk (2008) found that the
amount of information disclosed decreases after litigation, suggesting that firms may perceive ‘extra’ disclosure as being costly.

Bad news disclosures, and the release of bad news information, have also been studied in great detail and in many cases have been aligned with these sociological, political and psychological arguments – impression management theory, legitimacy theory and reputation risk management (see for example Leary and Kowalski, 1990; Skinner, 1994; Merkl-Davies and Brennan, 2007). Some commentators have found that although companies principally seek to engage in substantive\textsuperscript{75} disclosure practices or policies, others exhibit, on occasion, symbolic\textsuperscript{76} disclosures (see for example Day and Woodward, 2004; O’Dwyer, 2002), and it is these symbolic disclosures that are considered in more detail below.

The agency theory and political costs theory arguments become more interesting when dealing with risk relevant and value relevant information. Many commentators have looked at the competition between agency theory, political costs theory, legitimacy theory and impression management theory in the context of voluntary disclosures, and found sympathy or support for each of these arguments. What appears to be true is that justification needs to be found that explains why companies seek to close the information asymmetry gap when information is not costless, feasible and credible. In other words, managers face the problem of what they need to tell investors, set against what they want to tell investors.

2.6.6 Political costs theory, agency theory and signalling theory

Throughout the brief theoretical review sections above, certain theories have been covered namely: proprietary costs theory; impression management’ and legitimacy theory. However, there is also a secondary theoretical framework which supports these. There is an often unexplored link between the

\textsuperscript{75} Substantive disclosure is said to disclose information of events and positions in a way that is transparent and which shows things the way they are.

\textsuperscript{76} Symbolic disclosure often attempts to portray actions or positions in a manner that attempts to manipulate impressions or mislead.
economic theories, the sociological and psychological theories and positive accounting theories, where certain reporting constraints and requirements constrict the ability of management to behave exactly how they might wish.

The above review has shown that even when information is costless, feasible to produce and credible post production, it will not always be disclosed. Equally, in some cases, information that is costly (and, if we extrapolate this argument, possibly not credible or feasible) might be disclosed. This is because the cost-benefit pay-off ratio shifts dependent upon the information content. These costs and benefits arise as a result of agency and political costs and therefore these theories are examined in greater detail below.

2.6.6.1 Political costs theory

It has been argued above that the disclosures would be (theoretically) rarely deliberately withheld because of the high litigation costs related to non-compliance – but this does not mean that they are always provided, or always provided in full. In addition, there are occasions when the disclosure is provided in excess of the requirements. A proprietary costs theory does not explain this fully, nor do the sociological and psychological theories. Instead, as Watts and Zimmerman (1978: 112) noted, there are other factors, such as "tax, regulation, management compensation plan, bookkeeping costs and political costs" which affect whether a company accepts the required level of disclosure and whether they would be willing to suffer costs to avert it – or whether they would subsequently be willing to meet or exceed the requirements.

Despite many researchers' attempts to test the political costs hypothesis, positive accounting theory has not found a great deal of support empirically (Belkaoui and Karpik, 1989 – in relation to social disclosures; Ness and Mirza, 1991 – in relation to social disclosures; Lemon and Cahan, 1993 – in relation to social disclosures; Deegan and Hallam, 1991 – in relation to value added statements; Lim and Mckinnon, 1993 – in relation to disclosures by statutory authorities; Deegan and Carroll, 1993 – in relation to the pursuit of reporting
excellence awards). Nor has the theory met with much positive comment, receiving criticisms for its flawed logic (Christenson, 1983; Whittington, 1987), the method (Chambers, 1993) and even, on occasion, the ethical foundations (Mouck, 1995). Nevertheless, there is a reluctance to let go of this theory amongst the accounting research community. There are those who have appealed to fellow academics to assist with the demystification of the theory (Reiter, 1998), and there are those who believe that there is something intuitively believable about the theory, despite having found mixed evidence of it in practice (Milne, 2002). Instead, a review of prior studies indicated that it might not be the theory that was at fault (as outlined by Watts and Zimmerman [1978]) but instead the tests of the theory. Therefore, it is important not to be closed-minded about this theory as an explanation of financial instruments disclosures practice.

2.6.6.2 Agency costs theory

Financial instruments reporting is dominated by derivatives reporting and the risks associated with financial instruments. Smith and Stulz (1985) argued that the management of an entity will deliberately adopt a pro-active hedging policy to achieve comparative advantage resulting from a risk aversion strategy. However, they stopped short of saying that this policy must first be announced to stakeholders. A significant problem associated with this policy is that a risk aversion strategy comes at a cost, and therefore might conflict with the corporate objective or/and the objectives of management. The costs of a risk aversion strategy will prevent a company from always pursuing a maximisation of shareholder wealth strategy and the costs could knock on directly to management performance, especially where they are reliant on performance related remuneration packages. Hedging will almost certainly form a significant part of a risk aversion strategy and thus might have a negative effect on profits and a negative effect on investors’ perceptions of value maximisation (Allayanis and Weston, 2001; Jin and Jorion, 2006).

Managerialism is described as “self-serving behaviour by managers at the shareholders’ expense” (Pike and Neale, 2006:13). Managerialism does not
necessarily solely relate to issues such as buying luxury company vehicles, but also to adopting policies of a more self-preservatory, or worse still, bonus-driven nature (Eun and Resnick, 2007). This suggests that there is a conflict between a risk reduction strategy that is fundamentally self-preservation, and one which might also compromise performance bonuses. Therefore, hedging cannot be pigeon-holed and, one might suggest, there is some correlation between the mixed results of cost reduction strategies identified by prior research and the likely mixed attitudes of management towards adopting an efficient hedging policy.

An important point to note is the effort taken in recent years to avert agency problems. One of the key means of addressing the issue has been for owners (and regulators) to align remuneration packages to firm value (Eun and Resnick, 2009). Schemes are being tailored to take into account cost of capital and long-term wealth, and are producing immediate and longer-term benefits for investors (see for example EVA® [developed from the work of Stern Stewart] Johnson and Bamber, 2007; or Shareholder Value Analysis (or SVA) developed from the work of Rappaport, 1986).

Goal congruence has improved through guidance on best practice compensation contracts, especially as a result of the recommendations of the Cadbury Report (ecgi.com, 1992), Higgs Review (frc.org.uk, 2003), Smith Report (frc.org.uk, 2003) and the disclosure of information recommended by the Directors Remuneration Report Regulations (opsi.gov.uk, 2002). Nevertheless, there is a perception that the reduction or increase in volatility in earnings will positively or negatively respectively affect the expected income of the manager, regardless of the longer term effects. Moreover, when the roles of manager and owner are divorced, there is an increased risk that the agency problem might facilitate an inappropriate hedging policy. In addition, Groarke and Colbert (2005) identify that IAS 39 has exacerbated a potential communication issue, as accountants, risk managers and transaction originators need to cooperate. This has not always been an easy internal compromise.
Those firms who are using performance as a measure will find that management attitudes have a potentially huge impact on the hedging strategy a firm adopts (Smith and Stulz, 1985). When Smith and Stulz (1985: 400) examined management attitudes to hedging under various conditions, they arrived at some interesting conclusions. They found that “if the manager’s end-of-period wealth is a concave function of the end of period firm value, the optimal strategy is to hedge the firm completely”, thereby most likely over hedging. Secondly, “if the manager’s end-of-period wealth is a convex function of the end of period value of the firm, but the manager’s expected utility is still a concave function of the end-of-period value of the firm, the optimal strategy generally will be to eliminate some, but not all, uncertainty through hedging” (p. 401). This could lead to deliberate over or under hedging, dependent on the payoff between risk aversion of the manager and the potential variability of returns. Thirdly, “if the manager’s end-of-period utility is a convex function of the end-of-period firm value, Jensen’s Inequality implies that the manager’s end-of-period utility has a higher expected value if the firm is not hedged at all” (p. 401), potentially leaving the firm significantly under hedged with the same strategy a risk-seeker might adopt.

If this argument holds then one is forced to conclude that if a hedging related cost reduction strategy is adopted by a firm, then it will be subject to management influence and agency conflicts. An effective strategy will at best be tolerated by management, but more often than not will be impeded and thus deliberately made imperfect. At worst, management will deliberately obstruct an otherwise effective policy as part of a self serving philosophy. Thus, when it comes to disclosing the policies, processes and management of the risks, then these will also be subject to managerial manipulation.

This conclusion has been borne out in the work by Supanvanij and Strauss (2006) and Marsden and Prevost (2005). Supanvanij and Strauss (2006) found evidence that executive compensation schemes affect hedging decisions. For instance, they found that when a firm uses share options to incentivise management, there is a decrease in derivatives activity, whereas when a firm offers shares by way of compensation, hedging activity increases.
They found that SFAS 133 exacerbated pre-existing agency conflicts. Marsden and Prevost (2005) found that board composition has an impact on derivatives usage. They showed that companies with higher growth opportunities and a greater proportion of outside directors with lower ownership levels, were less likely to use derivatives, as they would be keener to encourage earnings volatility.

Due to the nature of modern globalised trading patterns, particularly those of large listed multinational companies, financial instruments management forms a major element of operational and financing strategies. The objectives, policies, processes and methods for managing the risks associated with financial instruments have therefore become important, and of key significance is what the company subsequently tells their investors and other stakeholders about their risk management programmes. It may be that once risks have been seemingly hedged by managers, there are incentives to engage in even more risky activities, that management would otherwise avoid, and that may be contrary to the goals of shareholders. The incentive implications post hedging are as yet unknown.

2.6.6.3 Signalling theory

Despite the obvious importance of financial instruments on companies’ position and performance, prior to the release of Financial Reporting Standard 13 *Derivatives and other financial instruments: Disclosure* (in the UK) in 1989, the reporting of financial instruments, in particular derivatives, and the financial risks associated with these instruments, had been almost exclusively voluntary.

Ross (1977: 23) argued that “if managers possess inside information... then the choice of a managerial incentive schedule and of a financial structure signals information to the market, and in competitive equilibrium the inferences drawn from the signals will be validated”. This incentive-signalling theory was proposed and applied to capital structure decisions but it is
possible to extrapolate the idea to argue that the release of previously undisclosed information will be evaluated by the market (Morris, 1987).

Hasseldine et al. (2005) followed up work by Toms (2002) when they adopted a quality-signal approach. They sought evidence to support the hypothesis that environmental disclosure levels were related to corporate reputation, and found evidence that quality was a factor in reputation, but quantity less so. This is obviously an important conclusion for this study; however, their approach appears to be (at least partially) flawed. There is the inherent problem that it is difficult to disaggregate a disclosure related reputation enhancement from other characteristics, such as position, performance, industry and so forth. Unravelling disclosures within a mandatory reporting environment would further exacerbate this problem, and finding a credible and appropriate ranking system as a suitable proxy for corporate reputation (not associated with non-financial reputation) would be almost impossible. Thus, their study cannot be replicated. However, the conclusions are significant and can be tested. In other words, this study explores the conclusion that quantity is not always a suitable proxy for quality from a different perspective.

Though there is evidence of companies producing symbolic disclosures which closely link to impression management and legitimacy theory, there is also significant and robust support for the theory that information disclosures are frequently provided as part of a signalling strategy. Signalling theory holds that where information is free from bias, complete and fills the information asymmetry gap, then it will serve to inform analysts, minimise forecasting errors and ensure efficient and accurate pricing. Importantly, in the context of this project, there are those that have suggested that greater disclosure of hedging activities would lead to more accurate earnings forecasts (see for example Reynolds-Moehrle, 2005).

In the case of financial instruments disclosures specifically, Subrahmanyam (2005) noted that managers might wish to portray their company (operating of course under their stewardship) as having an efficient and effective hedging policy because of the implicit and explicit gains associated with good practice
in this area. The associated reputational gains will lead to reductions in perceived risk and thus costs of capital advantages over competitors. However, as noted earlier, he also concluded that it would be prohibitively costly for an investor to investigate appropriately whether any underlying problems with a company’s hedging strategy might exist. Shin (2006), on the other hand, reported that the market already goes some way to correct for self-interested disclosures.

Company valuation practitioners have stressed the importance of disclosure to their work. Palepu et al., (2007) for example, stated that managers use disclosure as a signalling mechanism to investors, and that this should be studied by analysts. Penman (2007) believed that company valuations should not be undertaken without a thorough and critical review of the notes to the financial statements.77

Thus, disclosures are also substantive in nature. The disclosure theories appear to be mutually exclusive; however, this does not have to be the case. In other words, companies will provide information where it is costless, feasible and credible to do so to highlight future threats, opportunities, strategies, activities, expected future gains and losses, and so forth, in a meaningful and accurate manner. However, where possible they are prone to add rhetorical, narrative, or presentational bias.

2.6.7 Production and pricing decisions

Though there is no specific theory which has suggested that production and pricing decisions underlie disclosure strategies, it is an area which probably deserves greater attention from researchers. The problem for disclosure researchers is that many oil, extraction and utilities firms disclose more than they need to, especially in areas where production and pricing decisions can be influenced (e.g. derivative positions) and which are critical to the success of both the individual firm and also to the industry as a whole. Rajgopal (1999)

77 Known as footnotes in the US.
concluded that there was a relationship between the perception of oil and gas price sensitivity and price risk exposures. In addition, Kanodia et al. (2000) noted a further economic consequence of hedging disclosures, when they found that for certain industries financial instruments disclosures inform production decisions. Thus the reporting of financial instruments, which serve to indicate this sensitivity, appear useful to investors. The mainstream theories would seem to suggest that this information would be withheld if possible.

Disclosure theorists would argue that this information is feasible, credible but not costless, and therefore would be withheld without any offsetting reason. Agency theory holds that there are costs and gains arising from information asymmetry but ultimately these companies should be disclosing to an equilibrium position at worst (Eisenhardt, 1989). The disclosed information goes beyond this level. Equally, the economic rationale states that if this information is proprietary then it will not be disclosed. Dye (1990) argued that there might be an externality demanding this information, but if each company refused to release it then the analysts would have to bear the costs of uncovering this information themselves.78 Impression Management theory and Legitimacy theory hold that information will be disclosed if the firm has performed poorly (bad news) or if a specific action or transaction needs to be legitimised, but this does not account for why all firms are disclosing this proprietary information. Thus, there must be a further explanation for this disclosure.

Simplistically, it could be argued that the information that is voluntarily disclosed over and above an accounting standard, or set of accounting standards, requirements which decrease an individual firm’s competitive advantage, may be released for one of four reasons: first, analysts have requested it; second, because the firm is filling an information asymmetry gap and the benefits outweigh the costs; third, because other companies in the same industry are disclosing it and the costs of non-disclosure outweigh the

78 Which, having interviewed senior analysts, is possible to do.
benefits of withholding the information; or finally, because this is a cooperative arrangement across the industry to assist the liquidity of the product, allowing accurate price setting systems.

Studies of companies operating in the regulated industries have found that the disclosures contain significant additional production and price sensitive information in excess of that required (Rajgopal, 1999). This would be particularly useful to competitors and becomes part of a cooperative agreement. A combination of observation and intuition tells us that those who are non-cooperative suffer risk premia adjustments from analysts who perceive the non-disclosure as an admission of under-performance or bad news.

It is worth noting that Rajgopal’s (1999) arguments were based on the regulatory requirements in force at that time, and it has been found that the quantitative disclosures were not extensive enough to allow this conclusion to be drawn with absolute certainty (Linsley and Shrives, 2006). In addition, Rajgopal’s position can be criticised because of the uncertainty of the term ‘risk’, especially as investors views were (and are) difficult to assess with regards to this abstract concept (Linsley and Shrives, 2006; Hodder et al., 2001; Beck, 1998). In the light of the definitions and extensive disclosure requirements set out by IFRS 7, this issue should once again be revisited.

2.6.8 The influence over accounting standard setters: the political economy of accounting; and regulatory capture theory

This project attempts to rationalise full, excess, partial and non-disclosure within a theoretical context. In addition, the study addresses the question of whether the accounting standard has been biased towards any disclosure group. If it has been, then the levels of compliance and thus the associated levels of quality will be skewed. This lack of integrity in the results would render the conclusions invalid. Only by knowing that every company is exposed to an unbiased set of rules can we conclude that they all had an equally fair chance of achieving full compliance. There is a rich lobbying
literature which has identified various theoretical explanations to explore. The relevant theories are briefly outlined and in Chapter 7 these are tested and discussed further.

The political economy of accounting framework (Cooper and Sherer, 1984; Sikka, 2001) has allowed researchers to identify the standard setting due process as a system that is dominated by several conflicting groups who seek to defend and perpetuate their own interests (Hooks and Moon, 1993; Weetman et al., 1996; Saemann, 1999). Regulatory capture theory suggests that certain regulated industries, such as financial institutions or oil and gas entities, *capture* the regulators and thus exert greater pressure than other stakeholders. Economic theories of regulatory capture have suggested that regulation is sometimes produced in response to demands from the participants (Posner, 1974).

2.6.9 Summary

The theories briefly outlined above are not a complete list of all possible theoretical explanations for full, partial, over or non-disclosure in a mandatory reporting context. However, these explanations provide the starting point for an investigation into the mandatory reporting requirements of IFRS 7. Each of these theories is explored in more detail in the chapters that follow. Alternative theories and frameworks that could theoretically be used to explain the motivations for financial instruments disclosure, such as social network theory (e.g. Burt, 2000; Coleman, 1988, 1990) and symbolic violence and the overlapping and convertible forms of capital (Bourdieu, 1977, 1985), have not been discussed in the prior literature and are excluded from this thesis in the interest of economy.
Chapter 3 Research methodology: The epistemological, ontological and axiological considerations

3.1 Introduction

It is essential that a critical researcher explores and articulates their own, and their counterparts' work, particularly the underpinning philosophical assumptions. These assumptions are important as they highlight key issues such as the views held regarding the nature of man, society, organisations and knowledge. During the following sections the researcher identifies and examines the philosophical assumptions that guided this research (e.g. Bryman and Bell, 2007; Neuman, 2003). This chapter is concerned principally with methodology and not research methods. However a brief discussion of methods is required as the methodological position was the key driver for the mixed methods approach adopted. The methods are considered in greater detail, along with their limitations, on a chapter-by-chapter basis.

3.2 Research philosophy: Background

Methodology commentators have asserted that a researcher’s ontological and epistemological stance will guide a study as a whole (e.g. Neuman, 2003; Creswell, 2003; Bryman and Bell, 2007). The position adopted will contribute to the derivation of the research question(s). In addition the research philosophy will guide the approach used to address the(se) question(s) and the methods of analysis employed to investigate the question(s) (Ahrens and Chapman, 2006). Thus social science researchers, such as those in accounting, share the common bond with all disciplines that it is necessary for one to be aware of the philosophical assumptions related to the empirical world and the perceived relationship between theory and knowledge (Chua, 1986).

Epistemology is defined as “the nature of an explanation: what methodology to use, what logical structure it must [sic] have, what proofs are required, or how do we know that our knowledge is knowledge” (Craib, 1992 quoted in Roos, 2005: 196). Bryman and Bell (2007: 16) consider the epistemological
issue as “an issue concerning [sic] the question of what is (or should be) regarded as acceptable knowledge in a discipline”. Epistemological assumptions can be mapped along a continuum with positivism on one extreme and interpretivism on the other. This shall be returned to shortly because alongside epistemological considerations one needs to consider ontological questions. Bryman and Bell (2007: 22) argued that “the central point of orientation here is the question of whether social entities can and should be considered objective entities that have a reality external to social actors.”

It is commonly stated that there are two (opposing) ontological positions: objectivism; and constructionism (or constructivism). Advocates of the former believe that “social phenomena and their meanings have an existence that is independent of social actors” (Bryman and Bell, 2007: 22) whilst those who hold with the latter constructionist stance argue that (p.23) “social phenomena and their meanings are continually being accomplished by social actors”. In other words constructionists believe that the world is constantly being revised as a result of social interaction. A further distinction between the two extremes of the ontological continuum – objectivist and constructionist – is whether there is an existence of a natural social order and specifically whether that reality is: orderly and lawful or random and chaotic; fixed or transient; and singular or multiple.

There are also other influences on the conduct of research and these are largely based upon the researcher’s axiological assumptions. One might presume that a researcher was value-free and that their study was entirely objective and free from bias. One could argue that in the absence of this characteristic then the research could not be considered valid and the conclusions would subsequently be rendered meaningless. Durkheim (1938: 31) wrote that “all preconceptions must be eradicated” for social facts to be generated and accepted. However, this assumption has been challenged and this hard-line attitude has come under scrutiny in more recent times (e.g. Bryman and Bell, 2007; Saunders et al., 2009). In fact, certain feminist

---

79 The further issues of practicality are ignored here and dealt with in the limitations section(s).
research (e.g. Mies, 1993) has argued that the idea of neutrality and indifference should be replaced in some fields by "conscious partiality" (p.68). In response to this concern, there is a growing amount of research in the social sciences that has become increasingly self-reflective by recognising, acknowledging and stating a researcher’s possible bias within their research (see for examples Shaffir and Stebbins, 1991). Ethnomethodologists are an example of a group of researchers who commonly indicate their bias and tend to provide a significant level of reflexivity in their work (e.g. Hopper and Powell, 1985; Uddin and Hopper, 2001). Hopper and Powell (1985: 429), for example, have argued that “there is no such thing as a totally objective or value-free investigation.” Bryman’s (1988) edited collection of accounts from qualitative researchers’ experiences of working with(in) organisations provides several examples of the openness of researchers to reveal their biases. There are many examples of confessional tales in ethnographic writing some of which are referred to by Van Maanen (1988).

It is commonly argued that there are two contrasting research paradigms: positivist and interpretivist (Saunders et al., 2009; Bryman and Bell, 2007; Neuman, 2003). This is not to say that research must either be positivist or interpretivist but that these are two extremes of a continuum. Positivist research is often deductive whereby the process starts with a thorough review of prior literature and theory, followed by a period of data collection, hypotheses are developed and tested and finally the findings lead to the revision (or confirmation) of theory. Bryman and Bell (2007: 16) sub-head their section on positivism as ‘a natural science epistemology’ which captures the essence of the position. A positivist would argue that social reality should be studied by applying the methods, processes and principles of the natural sciences. Thus positivist research can be said to be the process of collecting data and testing generalisable propositions to verify factual information (Pugh, 1983 in Bryman and Bell, 2007). Advocates of positivism are thought to work under the assumption that knowledge is built up as a result of testing and observation. The ontological assumption of the positivist is that the external environment determines and constrains social reality and the axiological
assumption is that the process of research is value-free (Saunders et al., 2009).80

Empiricists have attempted to address the concept of truth and have argued that science is simply looking to carefully and systematically construct statements about the world and either refute or find evidence to support them (Smith, 2003). There is a philosophical school that claims to build on the positivist position and remain within this ‘scientific method’ model – postpositivism (Creswell, 2003; Phillips and Burbules, 2000). Postpositivists challenge the traditional notion of the absolute truth of knowledge (Phillips and Burbules, 2000). This school of thought holds that causes probably determine effects and that through careful observation and measurement a researcher can test discrete hypotheses. Thus through research one makes claims which are subsequently refined or abandoned. There is an acceptance amongst postpositivists that one does not prove hypotheses but instead indicates a failure to reject. The principle is that research works towards developing relevant true statements in an objective manner.

There is a vast (post)positivist literature related to the study of corporate disclosure.81 However, it should be noted that there is also a growing body of research that is interpretivist, especially in the developing field of social and environmental reporting. This study is theoretically grounded in a positive economic based theory of the firm where decisions about disclosures are initially made on a measured basis starting with considerations of cost versus benefit balanced against the regulatory requirements (as discussed in review papers such as Verrecchia, 2001 and Healy and Palepu, 2001). However, though this project maps closely to the postpositivist paradigm, as will be discussed in more detail below, this is a mixed methods study and does not sit at this extreme of the paradigm continuum.

Advocates of interpretivism hold a different set of philosophical assumptions. Their view of the world is critical of this ‘scientific model’. Instead

80 In an accounting context Zimmerman (1980) and Watts and Zimmerman's (1978; 1990) work on positive accounting theory covers similar arguments.
81 See literature review chapter.
interpretivism holds that researchers need to respect that people and objects fundamentally differ. Interpretivists argue that there is subjectivity in the interpretation and meaning of actors and their actions in the social world. Thus, interpretivists will most likely view the relationship between research and theory in a different way to positivists and this frequently leads to a contrasting approach to the collection and analysis of data processes. Interpretivist research is commonly inductive rather than deductive. Inductive research is aligned with theory development rather than theory testing.

It is possible to find evidence of accounting research underpinned by both the positivist and interpretivist philosophical assumptions (Bhimani, 2002). However, this discussion of research paradigms and categorisation causes problems in itself. Kuhn (1970) argued that paradigms are incommensurable i.e. they are inconsistent with each other. Over time, Kuhn argued, new paradigms are born out of crisis and revolution. The new paradigm will reign supreme until the next crisis and ensuing revolution overturns that governing paradigm and becomes dominant in its place. Theorists have been critical of this argument of incommensurability laid down by researchers (such as Kuhn and Burrell and Morgan) and argued that the boundaries between paradigms are permeable (Reed, 1985) or that the paradigms co-exist because of critical reflections on competing approaches (Willmott, 1993). On the other hand, certain authors such as Deetz (1996: 191) simply seek to “fight the tendency to reduce conceptions to categories”.

Several models have been presented but none have rivalled the popularity of the four paradigm model developed by Burrell and Morgan (1979) regardless of the arguments above (Pfeffer, 1982; Rao and Pasmore, 1989). Burrell and Morgan’s (1979: 1) thesis is underpinned by the idea that “all theories of organisation are based upon a philosophy of science and a theory of science”. The model consists of the following classifications: functionalist; interpretative; radical humanist; and radical structuralist. These arise from the interplay between objectivist and subjectivist philosophies (on one axis) versus regulatory and radical assumptions (on the other). Deetz (1996: 191; 192) argued that the popularity of the model stems from the clarity of its
presentation, the level of research and the advantages for researchers to be able to categorise and lend credibility to their research (particularly those whose research does not fit within the dominant functionalist quadrant).

Hassard (1991) adopted a multi-paradigm approach based on Burrell and Morgan’s (1979) model looking at the British fire service. He documented that each paradigm provided a legitimate frame of reference and concluded that from each of the four paradigmatic studies significant contributions arose. Gioia and Pitre (1990) argued that a study using a multiple paradigm model could be more comprehensive as it will see the research (and the object of the research) from different perspectives. Brown and Brigall (2007) believed that accounting research draws theory and uses methods from many disciplines and thus it is natural for multiple paradigms to co-exist.

Disclosure research is a genuinely multi-disciplinary multi-paradigmatic research area. Contributions have arisen from many fields including accounting, finance, economics, psychology, mathematics, law, medicine and so forth. This project is an empirical objectivist study that investigates the world of business assuming that the purpose of research is to describe what is happening and provide rational explanations of decisions, events and occurrences. The investigation and arguments put forward suggest minor changes to processes, management and organisation but the aim of the research (or the researcher) is not to tell the organisation how it should behave. Thus this work would most likely be classified as functionalist in Burrell and Morgan’s (1979) four paradigm framework. As Grant and Perren’s (2002) paradigmatic analysis of papers published in entrepreneurship research and small business journals during 2002 showed, the majority of articles (32 of 36 papers) were broadly functionalist. Jennings, Perren and Carter (2005) have encouraged research from the other Burrell and Morgan quadrants not to “discredit... functionalism but rather to accept paradigmatic pluralism [sic]” (p.151). In fact, in support of the dominance of functionalism and the research that has arisen from this domain they stated: it (p.147) “aspire to employ well-regarded scientific methods and normally has the agenda of improving some aspect of economy, society, or entrepreneurship.”
There is a vast amount of prior disclosure research that has employed an empirical approach to test the underpinning theories. The contribution of this study comes partially from the empirical evidence and the rationalisation of the findings. This work contributes to the theoretical debate by finding evidence that rejects some hypotheses but not others. Zimmerman (1980) argued that positivist research could contribute to knowledge by testing theory and generating new knowledge as well as refuting hypotheses and forcing a reconsideration of existing theory. Beams (1969) argued that accounting research was particularly well suited to a positivist approach that was underpinned by empiricism given the relationship between the academic discipline and the real world. In the accounting context, observation and testing are intended to translate acquired beliefs into factual information. Beams (1969) argued that this could only be achieved by quantitatively analysing data collected.

3.3 Research strategies – mixed methods approach

It is argued that quantitative and qualitative data collection and analysis methods can be aligned to epistemological and ontological positions (e.g. Bryman and Bell, 2007). Quantitative research has been said to be associated with positivism whilst qualitative work is commonly associated with interpretivism. This strict link is often disputed. Prasad and Prasad (2002: 6), for example, argued that some approaches to qualitative research can lead to, or be regarded as, “qualitative positivism”. It is commonly held that these extreme positions are inappropriate and instead there are advantages to combing quantitative and qualitative methods (Rocco et al., 2003). Mixed methods approaches to research originated in 1959 (Campbell and Fiske [as cited by Creswell, 2003]) to test the validity of psychological traits. The advantage of combining the collection and analysis of quantitative and qualitative data primarily arises from the ability to triangulate findings (Jick, 1979). It has been argued that all methods have limitations and drawbacks but when a combination of methods is employed then these weaknesses can be somewhat neutralised (Creswell, 2003). The combination of methods and triangulation can benefit research in many ways. For example, the findings
from one approach can be developed and informed by the findings from another approach (Greene, Caracelli and Graham, 1989). Tashakkori and Teddlie (1998) argued that one method could be nested within another and this would provide greater insight into specific issues.

Many disclosure studies have used exclusively quantitative research approaches, and to a much lesser extent, qualitative ones. As Jack and Westwood (2006: 481) argued in their review of the state and position of qualitative research in the field of international business: “merely calling for more qualitative research is not enough; research must become reflexive and aware of its ontological and epistemological assumptions, political positioning and ethical obligations.” Thus this study in part attempts to answer this call. It is difficult to find mixed methods research but this does not mean that it is impossible to locate a small body of work that has sought to investigate disclosure decisions using a combination of quantitative and qualitative approaches.

The innovativeness of mixed methods research in disclosure research is borne out by Caron and Turcotte’s (2009: 272) who claim in their abstract that: “The originality of the [sic] paper... lies in its methodology – particularly the use of a mixed method.” This statement is slightly misleading as there is a small amount of prior disclosure research that has employed mixed methods. One early study, for example, investigating disclosure decisions by Gibbins, Richardson and Waterhouse (1990) collected and analysed quantitative financial data but also undertook a survey and interviews to support the findings. A later project by Wilmshurst and Frost (2000) is amongst a small minority that chose to look at environmental reporting using mixed methods for a large sample (62 companies)\(^{82}\). Studies by April et al. (2003) and Guthrie et al. (2009) both used content analysis and were supported by interviews. However, these prior works by April et al. (2003) and Guthrie et al. (2009) have been argued to be examples of a weak mixed methods approach given the lack of discussion and integration of the results of the separate methods (De Silva, 2011; Parker, 2005).

\(^{82}\) A sample size which is similar to the one for this project i.e. 66 companies.
Eisenhardt (1989) was an advocate of case study research and she encouraged an engagement with mixed methods approaches of which this is more often than not a key feature. The nature of this support related primarily to the issues of triangulation and the possibilities for theory development. With reference to management accounting field studies Ahrens and Chapman (2006) also argued in favour of mixed methods. However their arguments stem from the issue that (p.823) just as “statistical methods may be used in qualitative field studies, positivistic studies may rely on interviews.” Morgan (1998) provided a slightly watered down argument in favour of mixed methods approaches and claimed that this approach was appropriate where emergent theories were being tested. Though this project is principally deductive it builds on a triangulation method not dissimilar to a case study approach. In addition, some of the underpinning theory, such as impression management and legitimacy theory, are relatively emergent. The qualitative data are useful for understanding the findings from the quantitative data. Thus, a mixed methods approach has been deemed to be most appropriate.

Eisenhardt’s work concerned case study research and she named several researchers (p.535) who had engaged successfully with this type of work already. Young and Preston (1996: 110) discussed the lack of accounting case studies and cited two reasons for this: first, they claimed there were structural barriers to entry; and second, they claimed there were few scholarly, explanatory case studies. Nevertheless, the accounting and management literature has seen a number of case studies emerge (Parker and Roffey, 1997: 242; Humphrey and Scapens, 1996: 87). In addition, there have recently been a number of descriptive works that reflect on the processes and management of a qualitative and/or mixed methods research project including the issues of data gathering, collection and analysis (Irvine and Gaffikin, 2006; Humphrey and Lee, 2004).

In recent years several reviews of mixed methods in accounting research have been undertaken including those by Grafton, Lillis and Mahama (2011) and De Silva (2011). They found that there were examples of combining surveys and interviews and there were also examples of research that
combined content analysis (often disclosure checklists) with interviews. Discussions of mixed methods projects from the accounting discipline and beyond often report that this approach involves significant costs to the researcher and the research itself. Studies argue that there are the observable costs such as the additional time and energy required to collect the data and perform the analysis (e.g. De Silva, 2011). There are also non-observable costs such as the interpretation and triangulation problems that arise. In addition, qualitative and quantitative data are exposed to different potential biases and weaknesses and these need to be acknowledged. Supporters of mixed methods research believe that it presents the opportunity for greater depth of analysis and provides richer data on which to base conclusions (De Silva, 2011; Grafton et al., 2011).

3.4 The approaches adopted

Each individual chapter includes a description of the research method(s) adopted alongside a discussion of the benefits and limitations of that (those) method(s). Below is a brief introduction outlining how the project fits together as a whole as well as an introduction to the rationale for a mixed methods approach and how this aligns with the philosophical assumptions underpinning the study.

A mix of methods or approaches in a single study is becoming increasingly recognised as the third major research approach and is becoming popular across many disciplines (Johnson et al., 2007; Leech and Onwuegbuzie, 2009). It is broadly acknowledged that there are three separately discernible mixed methods strategies: sequential procedures; concurrent procedures; and transformative procedures (Creswell, 2003). Largely speaking, this study adopted a sequential procedure whereby the findings from one method expanded upon the findings from another. However, there were times at which the data was collected and analysed concurrently. The main advantage for adopting a mixed methods approach is that it allows data to be collected that “would not otherwise be obtainable by using the main method” (Morse, 2003: 191). Other related advantages include the ability to “answer research questions that the other methodologies cannot”; “provid[ing] better (stronger)
Morse and Niehaus (2009) argued that there should be a core component and a supplemental component to a mixed methods study. In this case the main method in this study was a content analysis of financial instruments disclosures and the supporting methods were a survey, semi-structured interviews and statistical analysis. The additional information also adds “the power of analysis to... a small sample size” as well as to “allow better inferences to be drawn facilitating [sic] a stronger integration of data and results” (De Silva, 2011: 92).

The data collection and analysis for this study began with a series of pilot interviews which informed a survey. The survey was then piloted and feedback from the original survey led to the adaptation of a number of the questions. The survey was then posted to the key stakeholders in the financial instruments disclosures process. The covering letter highlighted that the survey could be completed by hand or on-line and the link was provided to facilitate this. A stamped addressed envelope was included in an attempt to maximise the response rate. A second postal round followed the original one month later. One month after this, an electronic mail was sent with a link to the online survey plus an attached copy of the survey document in Microsoft Word format in case the participant wished to complete the survey by hand. The survey responses were collected and analysed and respondents were asked whether they would be willing to participate in interviews.

Whilst the survey responses were being collected the researcher undertook a compliance review in the form of a disclosure checklist. This content analysis provided the numerical data to be able to perform statistical analysis testing certain hypotheses developed from extant theory. The interview and survey data sought to triangulate the rationale posited for full, non- or partial disclosure as shown by the compliance review. When the compliance checklist indicated that there were areas of specific and systemic non- or partial compliance it was considered necessary to investigate further. It appeared that many respondents to the survey and in the interviews indicated
that there were areas of irrelevance in the accounting standard under investigation and the compliance review highlighted that these correlated closely to the areas of non-compliance. Finally, the comment letters were reviewed to further triangulate these findings. The data collected using content analysis showed high levels of agreement with the interview and survey data and there was also a strong pattern of agreement with the areas of non- or partial compliance. Prior work has argued that the comment letter process is open to bias (specifically from certain interest groups and this pressure arises from several factors including coalitions, regulatory importance, funding partnerships and so forth) and therefore statistical tests were performed to attempt to assess whether the comment letter process was exposed to these biases.

3.4.1 The quantitative approach

Quantitative approaches are most often associated with (post)positivist epistemological assumptions and objectivist ontological assumptions. Quantitative researchers argue that this research develops knowledge by a process of defining and then testing specific research questions or hypotheses (Creswell, 2003; Bryman and Bell, 2007; Saunders et al., 2009). This is an approach dominated by quantification in the collection and analysis of data. Unlike qualitative approaches which are often seen as being underpinned by an inductive approach to relate theory to research, quantitative approaches are commonly seen as deductive. More often than not the qualitative processes employed in this study assisted the interpretation of the quantitative results.

The content analysis of the financial instruments disclosures related to the IFRS 7 requirements in the annual reports of the sampled firms quantified the level of compliance (and identified areas of partial and non-compliance) and the volume of disclosures. The content analysis of the comment letters quantified the level of satisfaction with the proposed requirements alongside the outcome-oriented, theoretically-oriented and other arguments. The survey data was collected to move towards an understanding of the level of approval for IFRS 7 as well as to try to gauge attitudes towards the decision-making
usefulness of the standard’s requirements and ultimately users' perceptions of the quality of the standard. The combination of this evidence allowed the development of hypotheses which were tested for statistical significance.

During the quality versus quantity (of financial instruments disclosures) chapter the researcher tested for potential relationships between the dependent variables – the level of compliance and the quantity of disclosures – and the independent variables. The independent variables related to issues driven from prior literature and theory. Thus the hypotheses were a series of tentative statements of relationships that were tested based upon the possibility of a likely link between cause and effect. Where hypotheses are rejected then the original theory can be questioned (and revised) and where hypotheses are not rejected the theory can be built upon or developed.

The chapter concerning the analysis of the relative strength of respondents during the comment letter process took the level of success of comments as the dependent variable. This was derived from an analysis of the requested changes and a reconciliation of the changes made between the exposure draft and the standard itself. This quantification of success, once again, allowed the development of a series of tentative statements to be tested. The independent variables were largely drawn from a combination of theoretical underpinnings and prior work.

Some voluntary disclosure researchers have argued that content analysis research needs support from other research methods (e.g. Holcomb et al., 2007; Lee, 2009). Parker (2005) noted the growing popularity of collecting and analysing interview data to substantiate quantitative evidence particularly. The survey data and interview data indicated a possible additional relationship that has not featured in comment letter research to date – the strength of geographical bias in the standard setting process. Therefore this was also introduced as a possible explanatory variable.
3.4.2 The qualitative approach

Qualitative approaches are often driven by constructivist assumptions insomuch as they analyse meanings of individual experiences with the intention to develop a theory or recognise patterns (Creswell, 2003). Bryman and Bell (2007) describe qualitative research as a strategy driven by interpretation and, thus by default, not quantification. A qualitative approach attempts to discover meaning by isolating themes from words and images. This thematic analysis allows the researcher to begin to interpret and understand the social and cultural context of disclosure decisions.

This project employed qualitative analysis in the form of interviews. The primary strength of interviews is that it allowed an interpretation of the quantitative results through direct engagement with the key stakeholders (De Silva, 2011). Neuman (2003) argued that qualitative approaches can facilitate the building of an overall picture of the data. The qualitative data captures thematic explanations and these often provide cohesion to the conclusions drawn from the quantitative data. It has been argued that human behaviour cannot be understood solely by observation and thus informal interviewing allows an insight into the social and cultural context that quantitative methods does not (Atkinson and Shaffir, 1998). Semi-structured interviews were conducted as it is thought that this approach allows for “freethinking by interviewees” and thus alleviates some of the problems associated with subjectivity (Cavana et al., 2001).

The data helped generate a more holistic understanding of the attitudes towards the disclosures from a quality perspective and also aided the assessment of the possible issues related to the usefulness, or lack thereof, of the mandatory financial instruments disclosures. As prior research has shown, there are complex behavioural, social and psychological rationale for the management and presentation of certain disclosures and therefore this approach enabled the researcher to gain a richer understanding of these social and human issues. Many have argued, alongside commentators such as Eisenhardt (1989) or Rouse and Daellenbach (1999), that these qualitative
approaches to data collection and analysis allow the researcher to attain a greater understanding of the complexities created from the social world.

3.5 Conclusion

A mixed methods approach allowed the quantitative data to be viewed thematically and holistically with the added benefits of (limited) triangulation. The additional benefits of combining interviews to survey responses stemmed primarily from the belief that disclosure decisions are not solely driven by the economic function but there is also a social and behavioural complexity. Thus, potentially deeper and richer conclusions can be drawn from the findings. Each chapter discusses the methods employed and also attempts to document the limitations and drawbacks associated with their use. The purpose of this chapter has been to describe the various methodological approaches available and attempt to place this research within that framework. Ultimately, this work is underpinned by empirical postpositivist objectivism but it should be noted that it is not pegged to the extreme.
Introduction to Chapter 4

This project has comprised several stages of analysis and in the process combined various methods. The following chapter introduces some of the key empirical data arising from the compliance review of IFRS 7 disclosures. The entities examined were the FTSE 100 non-financial IFRS 7 compliant firms. The disclosure reviewed covered the first time adoption period. In other words, the financial statements under scrutiny related to year ends commencing on or after 1 January 2007. The core contribution of this particular chapter arises largely from this first comprehensive review of the financial instruments disclosures in the UK. In addition, this is the first study to provide possible rationales for financial instruments reporting practices including a conceptual framework that presents a range of possible explanations for full, partial or non-compliance. Where appropriate, these discussions are supported by evidence from a review of comment letters and interview data gathered from key stakeholders.

Prior studies have found compliance with the reporting requirements of accounting standards to be mixed. Additionally, several reviews of the financial instruments disclosures have described the information provided as being incoherent and overly complex. The findings of this research exercise do not mirror these findings. Though some of the financial instruments disclosures are straightforward because of their nature and scope, such as the hard rules-based information related to trade receivables, this is not true for others. This is especially true for the disclosure of financial instruments and their associated risks. A combination of the complexity in usage and management of these instruments ensures that the related disclosures are more often than not intricate and dense. However, having made this point, the review found that the relevant notes were clear and coherent in almost all cases. In addition, these disclosures followed recognisable patterns from one entity to the next.

The mean overall compliance result was 94%. This is significantly higher than that found by prior studies carried out in other jurisdictions under similar
accounting regulations. It is important to note that all companies are audited by the elite firms, they are all leaders in their respective markets with large levels of analyst following and thus any level of non-compliance is difficult to justify. Therefore, though the compliance levels are high, the areas of partial or non-compliance need to be investigated in further detail.

There are several potential explanations for full, partial or non-compliance. However, as these disclosure decisions are made privately this means that this study, alongside any of this type, suffers from the inherent limitation that conclusions are broadly subjective. Therefore, where possible, the results are reported on the basis of most likely outcomes (or explanations) and are presented along with supporting qualitative and quantitative data.

This study found that compliance issues were largely clustered around certain reporting areas such as reclassification, defaults and breaches, unlisted investments accounting practice and policy and sensitivity analysis. Arguably these reporting errors or omissions could be due to preparation error and subsequent audit failure. However, it would seem unlikely that this should be the explanation for all compliance failings, primarily because of the following factors. Those firms in the sample are audited by the elite status firms and thus benefit from the expert service; interview evidence shows that audit staff, management and key personnel received significant levels of training in relation to meeting the financial instruments reporting requirements; these are high status entities and thus are subject to a high level of scrutiny from their analysts, investors and media. Therefore it is necessary to consider the possibility that there are other potential rationale for partial or non-compliance. Possible explanations put forward are legitimacy, impression management and proprietary costs issues.
Chapter 4: Mandatory reporting compliance issues and a suggested rationale

Purpose: This chapter makes two contributions to the existing literature: first, this is the only full IFRS 7 *Financial Instruments: Disclosures* compliance study; and second, a conceptual framework has been prepared and presented that helps to bridge the gap in the literature between the theoretical underpinnings related to the purposes of disclosure and the empirical evidence of full, partial or non-compliance by asking the question ‘why do entities choose (not) to disclose certain information?’ in addition to the questions ‘what?’ and ‘where?’.

Design/methods/approach: A content analysis of the FTSE 100 non-financial IFRS 7 compliant firms. Based on these results, on a case-by-case basis, this study addresses potential causes and rationale for full, partial or non-compliance. These discussions are supported by evidence gathered from a review of the comment letters related to ED 7 and by interview data from key stakeholders where appropriate.

Findings: In stark contrast to prior research, this review found the level of compliance to be high. Also contrary to prior studies, it was not found that incoherence and lack of uniformity were problematic. Evidence is provided of full, partial and non-disclosure that is consistent with both the legitimacy (reputation enhancement) and impression management theories of prior voluntary disclosure studies. Though disclosure levels were generally high, the review consistently identified evidence of non-compliance with certain areas, such as sensitivity analysis. This is worrying primarily because the entities considered by this study are the largest non-financial firms listed in the UK, and they are all audited by the *elite* Big Four audit firms.

Key words: Financial instruments; mandatory disclosures compliance
4.1 Introduction

Through the past two decades there have been calls upon standard setters to improve disclosures related to the usage, management and disclosure of financial instruments, in particular derivative financial instruments and their associated risks (e.g. Chalmers and Godfrey, 2004; Berretta and Bozzolan, 2004; Linsley and Shrives, 2005). This has resulted from a general scepticism amongst certain groups about whether these instruments are being used by companies for traditional risk management purposes or whether they are being abused or misused (e.g. Sapra and Shin, 2004). It is thought that this problem is sometimes caused and often exacerbated by overly complex accounting standards, which have impaired the core qualitative characteristics of financial reporting (Woods and Marginson, 2004; Hernandez Hernandez, 2003).83

To gauge the extent of derivatives based risk management practices amongst the sample of firms covered in this study, the data presented in table 5 outlines the level of derivatives usage mapped against the type of risk being managed. Further analysis of this data appears in the results section (4.4). In addition, a full company by company analysis of derivative financial instruments usage appears as appendix A.

Calls for greater transparency, especially related to derivative financial instruments disclosures84, have arisen due to the increased complexity and usage of these instruments, and thus in turn an increase in the associated risks, during a relatively short period of time (FASB, 2002; Linsley and Shrives, 2005). The Bank for International Settlements triennial review of foreign exchange traded derivatives (2007) showed that the average daily turnover was at $3.2 trillion in April 2007. In comparison with April 2004, this represented an increase of 63% (at constant exchange rates). Similarly, the

---

83 See section 1.1.2 for discussion of FRC (2009; 2011) and ICAS (2010) debate about reducing complexity from annual reports and de-cluttering the disclosures.
84 The FASB (2002) proposal related to principles-based accounting (discussed in section 4.4.1 below) drew particular attention to SFAS 133 and presented an alternative principles-based approach to financial instruments reporting in an appendix to that document.
Financial Services Authority (2009: 14–15) reported that the volume of credit derivatives increased from less than $10 trillion in the first half of 2004 to just under $60 trillion in the first half of 2008. This explosive growth enabled investors and traders to hedge or create synthetic credit exposures.

Table 5: Analysis of derivatives by risks managed

<table>
<thead>
<tr>
<th>Risk Management</th>
<th>Assets £mill</th>
<th>Liabilities £mill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign exchange risk management related derivative instruments</td>
<td>6,376.8</td>
<td>(3,562.5)</td>
</tr>
<tr>
<td>Interest rate risk management related derivative instruments</td>
<td>2,890.7</td>
<td>(1,759.3)</td>
</tr>
<tr>
<td>Cross currency risk management related derivative instruments e.g. swaps</td>
<td>4,902.8</td>
<td>(2,651.0)</td>
</tr>
<tr>
<td>Market risks management related (e.g. commodities) derivative instruments</td>
<td>30,928.6</td>
<td>(35,627.5)</td>
</tr>
<tr>
<td>Equity/capital related derivative instruments</td>
<td>41.5</td>
<td>(131.6)</td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td>259.6</td>
<td>(32.0)</td>
</tr>
<tr>
<td>Unclassified / other derivative instruments</td>
<td>1,912.8</td>
<td>(3,056.3)</td>
</tr>
</tbody>
</table>

The requests for higher levels of disclosure were answered in a comprehensive manner by IAS 32 and subsequently IFRS 7. The annual report now contains a vast quantity of financial instruments related disclosure,
Mandatory disclosures are commonly boiler-plate (Calderon et al., 2007; Spira and Page, 2010). However, in this specific instance, the financial instruments disclosures for the year beginning on or after 1 January 2007 are different for several reasons. First, the issue of first-time adoption often throws up dissimilarities because of the lack of a standard template. There are several examples of this from the interviews. As interviewee 7 stated: “as we were implementing [the IFRS 7 disclosure requirements], you know, I think we found it tough to really get the complicated questions answered, and I think we found, I don’t know, I don’t know if we’re leading [the auditors] or not, but I think they were learning... I think we were learning, they were learning as we went along, and that’s the elite, the big four, London Office, so I think outside... it would have been difficult, yes.” Another preparer (interviewee 10) remarked: the implementation of IFRS 7 has “definitely been an interesting exercise... I was heavily involved in the disclosures this year, and it’s always such a massive challenge because it is new and because you don’t know what anyone else is going to produce basically, you don’t know what laundry your competitors are going to be washing. And with it being so new and so different to anything that’s gone in there before, it’s definitely presented a set of challenges.”

The second reason why these particular disclosures are non-uniform is due to the complexity of the requirements and a combination of rules (hard and soft) and principles demand specific (unique) qualitative and quantitative disclosures. Third, the disclosures are position and performance-related and are firm-specific, particularly where there is large derivatives usage and firms have developed their own policies, processes and management approaches. Finally, even if it were within their remit, audit firms would find it very hard to ‘write’ the disclosures for disclosing entities. This final point was brought out

85 These quantity figures are based on word count. Given the amount of tabular information, in terms of page coverage this increases to approximately 19% of the annual report overall and approximately 23% of the financial statements and notes.
by a number of the interviewees. Interviewee 8, for example, commented: “certainly the early reporters, like the first people to adopt… but those earlier documents, this is all written in-house. And so the auditor comes in, reads it, checks it, ticks the box and says, that’s fine, we’ll roll with that.” Another finance director (interviewee 15) said: “I write it [the financial instruments disclosures] and they [the auditors] check that what I’ve written is true. So, I write it and they check it.”

Due to the potential litigation costs and reputational damage for auditors of failing to report non-compliance with disclosure requirements, one is forced to ask why there is any non-compliance with this or any other standard’s requirements. This is especially true for the sample of firms chosen for this study given that all companies sampled were audited by the accounting firms commonly perceived to be the elite, i.e. the Big Four (Francis, 2004). Both audit researchers and professional commentators have long held that the auditing profession has a top tier who can charge a premium for their work because of the associated audit quality (McMeeking et al., 2006) and the reputational capital held (Francis and Wang, 2008). The greater assurance from Big Four work and the associated premium is usually attributed to either greater effort (more hours billed) or greater expertise (higher charge-out rates). This evidence implies that smaller audit firms will probably have (or are perceived to possess) lower audit quality levels and higher numbers of instances of non-compliance issues. Therefore, to the extent that the Big Four undertake the highest quality audits, the results of this study are especially worrying, assuming that the levels of non-compliance are potentially greater for firms outside of this elite tier.

Most theories of corporate disclosure conclude that, provided the information is credible, disclosures will be made if it is feasible to do so (e.g. Dye, 1985; Verrecchia, 2001; Healy and Palepu, 2001). Disclosures are made due to the

---

86 Later on, interviewee 15 queried this capability of the audit firms to “check it” as did interviewees 3, 7, 8, 9, 10, 11 and 19.
87 For further examples of interviewees discussing organisational differences leading to comparability problems (i.e. differences in the disclosure from one entity to another) see section 6.4.
88 This study defines the Big Four as: PwC; Deloitte; KPMG; and Ernst & Young.
benefits of a reduction of information asymmetry and an associated reduction in the cost of capital (Botosan, 1997; 2006). However, there is evidence from disclosure research and from information proprietary costs research that suggests that some disclosures might be promoted, marginalised, or omitted dependent upon the value placed on them by real or financial externalities, and thus there are additional associated cost (financial and non-financial) to making these disclosures (Dye, 1990) including their potential behavioural effects (Koonce et al., 2005; 2008).

This study is therefore grounded in the presumption that there will be some areas that will be complete, thorough and clear, such as hedging disclosures, given the association with risk reduction and value creation. However, the counter-prediction is that that there will also be areas of non-compliance for similar reasons. It is possible that compliance failures might arise as a result of the misinterpretation or misapplication of technical accounting and auditing standards. Intuitively, this argument holds water, but it is difficult to defend for several reasons. First, IFRS 7 carried many of the disclosure requirements of IAS 32 and any additional disclosure requirements were contained in ED 7, which was released in July 2004, leaving many months for preparers and auditors to prepare. In addition, the Big Four are extremely well resourced with technical experts, and they place a great importance on both audit quality and their brand reputation continuance. Thus, it is important to consider the possibility that there may be other possible explanations for partial or non-compliance.

The first explanation for non-compliance with a mandatory standard is drawn from the psychology and sociology literatures. There are two strands to this argument: impression management and legitimacy theory. Prior research has argued that there are gains associated with creating or managing one’s impression (see section 2.6.5.3), and this theory has been extrapolated from the individual context to the corporate organisation. In other words, companies might use the disclosure or non-disclosure of information to manipulate perceptions of position and performance (e.g. Brennan et al.,
Legitimacy theory holds that certain actions and events require information to be set within a context or a social norm (see section 2.6.5.2).

The second explanation for non-compliance lies in the difference between proprietary and non-proprietary disclosures. In this regard, proprietary disclosures can be defined as those which “reduce the present value of cash flows of the firm endowed with the information” (Dye, 1986: 331). Dye went on to argue in this paper that in the case of proprietary information non-disclosure or partial disclosure could be the optimum policy, even when credible announcements could be made and it would be feasible to do so.

If companies are producing disclosure which does not meet the requirements as set out by IFRS 7, then the users of financial information should pursue one of two courses of action: either insist on the inclusion of this material; or convince standard setters that the requirements should be removed from IFRS 7. As one interviewee (2) stated: “it all comes back to – it sort of sounds rude maybe - to the accounting profession. If they’re doing their job properly you should be helping people understand it and give them what they need”.

The remainder of the chapter is organised as follows. The next section presents an overview of the previous literature related to the purposes of disclosure, followed by a brief review of recent audit compliance work concerned with financial instruments. Section 4.3 outlines the conceptual framework and research methods adopted in the chapter. Section 4.4 presents and discusses the main statistical results related to compliance. Section 4.5 draws some conclusions and sets out the limitations of the study, alongside providing some areas and recommendations for further research.

4.2 Prior literature

There is a vast literature related to the purposes of firm-level information and annual report disclosures (see for example reviews by Healy and Palepu, 2001; Verrecchia, 2001; Botosan, 2006). However, as stated by Beretta and Bozzolan (2004: 268), “risk disclosure is just becoming a serious topic for
research” and there remains only a limited amount of work concerned with financial instruments disclosures in the annual report. Therefore, in the light of the release of IFRS 7, which became effective for entities with a year end commencing on or after 1 January 2007, the growing importance and volume of risk disclosures, and the increased attention on the use of financial instruments, this chapter seeks to address this gap in the literature.

Contrary to Lundholm and Van Winkle’s (2006) argument that disclosure is a question of timing rather than necessity – i.e. when rather than if – there is a school of thought that contends that some information will simply never be disclosed. If the information does not appear and there is no ex-post litigation, 89 then one might assume that any non-compliance was irrelevant. On the other hand, because of the principally confirmatory role of financial statements (Gigler and Hemmler, 1998), it should also be acknowledged and to an extent caveated with the possibility that it would be unlikely for interested parties to notice withheld disclosure given the private nature of secrecy. This view was echoed by all of the analysts interviewed with the exception of one who felt that it might be possible to reconcile with the use of information either sourced elsewhere or through other means.

4.2.1 The context of financial instruments disclosures: from voluntary to mandatory disclosures

It has long been argued that the primary purpose of firm-level disclosure is to minimise the information asymmetry gap between stakeholders and the company, and thus reduce the cost of capital (Botosan, 2006) and facilitate improved market efficiency and liquidity (e.g. Holland, 1998; 2005). However, this is not the only purpose that disclosure fulfils (See sections 1.5 and 2.2.3). Other benefits include the potential for managerial opportunism or optimism to: explain away poor performance; increase the liquidity of the firm’s shares and reduce contracting costs; reduce litigation risks; and guide perceptions of

89 In relation to partial or non-disclosure of financial instruments for my sample we are aware of no legal issues.
management performance and behaviour (e.g. Healy and Palepu, 2001; Leuz and Wysocki, 2008; Holland, 1998, 2005).

The voluntary nature of financial instruments reporting meant that during the period pre-IAS 32, accounting standards had, more or less, allowed companies to choose what they wished to disclose about their financial instruments and associated credit, liquidity and market risks (Chalmers and Godfrey, 2004; Linsley and Shrives, 2006). When a system exists whereby companies are allowed to decide what to voluntarily disclose, and how this information is disclosed, there is the risk that there might be a lack of transparency between reporting firms both in principle and practice. Holland (1998, 2005) noted the potential for the release of information through private disclosure and amongst the benefits was the opportunity to use this information to buy the confidence of those externals who were most important to the entity (without breaking the private sensitive information rules or any other laws or regulations).

Though there were criticisms of IFRS 7 and the reporting requirements therein – including over-reporting and potential obfuscation of information – all the interviewees agreed that the voluntary reporting system for financial instruments that existed pre IAS 32 needed to be reformed and, in turn, that IFRS 7 had led to improvements in the level of information availability. An industry spokesman and regulator (interviewee 5) stated: “in general I would say that the disclosures are of course helpful and needed in case of transparency.”

A senior analyst (interviewee 4) remarked: “What I wanted or asked IFRS 7 to deliver... was to disclose clearly off balance sheet liabilities. That’s what I was interested in, what I got was actually something in between.” The problem was laid at the door of IAS 39 measurement rules primarily by this interviewee. Another analyst echoed this statement (interviewee 18) and argued that: first, the standards ensure that clearer guidance is provided than previously; second, IFRS 7 had facilitated this; and finally, if balances were in doubt then they needed to be investigated further and possibly instruments
valued separately. This conclusion is echoed by Chalmers' (2001) study covering the move from voluntary to mandatory reporting who found an incrementally improving level of disclosure.

The idea that the standard is not perfect but offers an improvement on the voluntary reporting regime was brought out by interviewee 4 (an analyst). He stated that: “The [voluntary] system was worse because the companies could just do what they liked... companies essentially could just say what the hell they liked, and the problem is, you then get a problem whereby you've got companies firstly who want us to get punished because everyone else is playing the same game, your companies who look at that and say OK, we're not being dishonest but we're not going to reveal that information because it actually does us no good at all, which then allows those that wish to exploit that for the wrong purposes to be free to do so. So forcing them to disclose the existence of the instruments and making the balance sheet items more visible and cash flow cost is an improvement, but it's, like everything it's in the drafting of the standard. What I mean is... it doesn't do the job we'd hoped it would do, but it is better than nothing in terms of revelation.”

Linsmeier and Pearson (1997) believed that the SEC’s underlying rationale for the (initial) derivatives disclosure requirements, particularly those related to market risk, was that they were designed to provide useful information to investors. Certainly, this conclusion echoes the international standard setters’ principal objective for financial information.

4.2.2 The role of mandatory disclosures

Companies provide mandatory annual report disclosures to fulfil the demands placed upon them by standard setting and regulatory bodies. These requirements are written to enhance information usefulness, i.e. to make companies positions and performance more comparable, understandable, relevant, verifiable, timely and a more faithful representation. However, in addition to the documented benefits of social and environmental disclosure regarding legitimacy and impression management benefits, one might also
expect certain disclosures associated with adding value to be more prominent, clearer and more transparent. This is particularly true given the evidence supporting the behavioural relationship between certain risk disclosure phraseology and risk perception (Koonce et al., 2005; 2008).

In addition, a naive observer might expect there to be zero breaches of mandatory (financial instruments) disclosure requirements. However, as with prior studies, this was not found to be true (Bhamornsiri and Schroeder, 2004; Elmy et al., 1998; Jones and Wei, 2004; Nissim, 2003; Roulstone, 1999; Lopes and Rodrigues, 2007). Prior literature has provided several possible explanations for this partial or non-compliance. On a case-by-case basis this study addresses the questions why (or not) disclose in addition to what and where.

Unfortunately there is only a limited amount of prior work that has sought to investigate mandatory disclosure informational effects. Gigler and Hemmer (1998) concluded that mandatory disclosures play a mainly confirmatory role for investors, whilst Dye (1985; 1986; and 1990) focused largely on proprietary information partial or non-disclosure and whether there was the potential for a negative impact on existing information once disclosures became mandated. Dye (1986) challenged the assumption that full disclosure was always optimal when information was credible and costless, and found that this does not always hold. He found that there are occasions, principally for proprietary disclosures, when non-disclosure or partial disclosure might exist. As a footnote to the study, it was also investigated whether there was any evidence to corroborate Dye’s (1985) proposition that there is the risk that when disclosures become mandatory through accounting-led change, useful information provided on a voluntary basis could be lost. These results are presented in section 4.4.8 below.

Having reviewed the prior work, a conceptual framework was designed to allow an analysis of the determinants of full, partial and non-disclosure (Figure 1). Though this might not be a full summary of all possible outcomes, the
framework captures the majority of cases (see appendix C for an overview of the application of this investigatory conceptual framework).

4.2.3 Theoretical underpinning: the conflict between external and internal disclosure stimuli

There is currently a great deal of research into voluntary disclosures and this work has been adapted to provide a theoretical framework for disclosure strategies in the mandatory reporting environment. Voluntary disclosure studies, unlike mandatory disclosure studies, have tended to address the question why disclose (or not) as much (or even more than) the question what has been disclosed. It would seem that companies’ disclosures are motivated both by external pressures and also by internally driven corporate communication objectives. The external motivations are potentially twofold: firstly, to provide useful information for investors and other stakeholders; and secondly, meeting minimum disclosure requirements to ensure clean audit reports. Under the constraint that the information must be disclosed, the internal motivation becomes to ensure that the disclosure made either adds value or minimises losses, whether these be financial or non-financial.
Figure 1: Determinants of disclosure compliance

- Proprietary information?
  - Yes
  - Costs of disclosure outweigh negative effects?
    - Yes
    - No
    - Disclosure credible and feasible?
      - Yes
      - No
      - Deemed to lack relevance or usefulness
        - No
        - Evidence of an externality driving information requirements?
          - Yes
          - Financial Statements preparation error?
            - Yes
            - Competition sensitive/confidential?
              - Yes
              - Audit error likely?
                - No
                - Investigate further. Most likely explanation is impression management or legitimation.
                - Yes
                - Investigate further. Statutory obligation met
              - No
              - Investigate further. Statutory obligation met
            - No
            - No further investigation required
          - No
          - Investigate further. Statutory obligation met
        - No
        - Investigate further. Statutory obligation met
      - No
      - Investigate further. Statutory obligation met
    - No
    - Investigate further. Statutory obligation met
  - No
  - Investigate further. Statutory obligation met

- Indicates negative response
- Indicates positive response
Thus management often face an agency conflict between information they wish to disclose and information that is obligatorily disclosed\textsuperscript{90} (Lambert, 2001 [see in particular Chapter 4]). By default, this agency conflict and proprietary cost model is exaggerated in the mandatory reporting setting, as this information is used more by analysts and investors (Campbell and Slack, 2008; Vergoossen, 1993; Chang and Most, 1985). However, what is also clear from the voluntary reporting environment research is that management have unseen psychological and sociological motivations, principally, to create or manage reputations/impressions or to legitimise actions, decisions or events.

Organisational legitimacy refers to the concept that organisations might be willing to attempt to ensure there is an apparent symmetry between the social values, strategies and operations of the company and the “social norms of acceptable behaviour in the larger social system or environment they are part of” (Dowling and Pfeffer, 1975: 122). Prior organisational legitimation studies have focused on financial reporting (although most have ignored financial instruments) and more recently on environmental reporting legitimation practices (Aerts \textit{et al.}, 2008; Clarkson \textit{et al.}, 2008; Branco and Rodrigues, 2008; Bebbington \textit{et al.}, 2008). However, there have also been a handful of investigations into legitimacy theory in terms of financial instruments disclosures (for example Chalmers and Godfrey, 2004).

The issue is not solely one of legitimisation by disclosure, but also of obfuscation or omittance through non-disclosure. The research in this area has generally sought to isolate instances of impression management (Leary and Kowalski, 1990) through visual and narrative rhetoric – for example repetition, metaphor, imagery, graphics, photographs, or other presentational techniques within the annual report (Beattie and Jones, 2008; Beattie \textit{et al.}, 2008; Davison, 2008).

\textsuperscript{90} This is further exacerbated when management are called upon to disclose information they would rather not, i.e. bad news.
The major difference between legitimacy theory and impression management relates to intention and direction. The latter often involves a willingness to mislead, whilst the former wishes to corroborate, confirm or enhance. Thus, impression management is often associated with *storytelling* – particularly if there is bad news or the potential for information to be determined as bad news (Skinner, 1994; Merkl-Davies and Brennan, 2007). As an offshoot of this research, some commentators have found that although companies principally seek to provide substantive\(^{91}\) disclosures, others exhibit, on occasion, symbolic\(^{92}\) disclosures (Day and Woodward, 2004; O’Dwyer, 2002).

In the case of financial instruments disclosures, Subrahmanyam (2005) noted that managers might wish to portray their company as having an efficient and effective hedging policy because of the implicit and explicit gains associated with good practice in this area. This corroborates arguments about reputational gains leading to a reduction in perceived risk, and thus cost of capital advantages over competitors (Botosan, 2006). However, Subrahmanyam added that it would be prohibitively costly for an investor to investigate appropriately whether any underlying problems with a company’s hedging strategy might exist. Nevertheless, Shin (2006) found that the market already goes some way to correct for management making self-interested disclosures.

### 4.2.4 Financial instruments accounting standards compliance issues

Isolating breaches with accounting (or any other) standards is difficult and time consuming. Prior research has often assumed that non-compliance is reported in the audit report; however, this is an overly simplistic view. There have been a small number of prior studies that have focused on reviewing compliance with individual accounting standards, as is the case in this study. In each of these reviews, breaches in compliance have been found. Despite this, it is not uncommon for accounting researchers to assume full compliance. Prior studies have examined financial instruments disclosures from a value relevance perspective, under the

---

\(^{91}\) Substantive disclosure is said to disclose information of events and positions in a way that is transparent and which shows things the way they are.

\(^{92}\) Symbolic disclosure often attempts to portray actions or positions in a manner that attempts to manipulate impressions or mislead.
assumption that firms fully comply whilst noting that non-compliance is either a limitation or a possible explanation for inconsistent results (Seow and Tam, 2002; Wang et al., 2005).

With regards to the financial instruments disclosures, compliance reviews have been undertaken in the US with uniformly negative findings. Nissim (2003), for example, specifically examined fair value data for banks and found the information to be inconsistent. Elmy et al. (1998) argued that FRR 48 was designed to ensure disclosures of market risk were more comprehensive for derivative financial instruments, and concluded that the disclosures were unsatisfactory. They perceived that the disclosures, both quantitative and qualitative, suffered from a lack of clarity, contextuality and comparability for the main part. Roulstone (1999) also concluded that there were some major compliance issues related to companies’ adoption of FRR 48.

Two more recent surveys undertaken by Jones and Wei (2004) and Bhamornsiri and Schroeder (2004) found that compliance was mixed. Bhamornsiri and Schroeder looked at the compliance with SFAS 133 disclosure for the 30 companies that comprised the Dow Jones Industrial Average. They found that a large proportion of these companies declared that the value of their hedging activities was immaterial, and thus exempted them from certain disclosures. They observed that the derivatives information was not provided in a coherent manner and that hedging disclosures were scattered throughout the annual reports. They judged the information to be hard to understand, difficult to follow and lacking in uniformity. They claimed that even a practised and educated reviewer would find the information difficult to interpret, and that there was a general lack of consistency. Evidence of poor compliance is not limited to the US. A recent Portuguese study, for example, found that financial instruments disclosures compliance scores ranged from 16% to 64%, with an average of 44% (Lopes and Rodrigues, 2007).

4.3 Research methods

A disclosure checklist was designed (see Appendix D) based on the requirements of IFRS 7. This was subsequently cross-checked against those undertaken by the Big
Four to ensure that there were no material differences between these and the one used for this study. In total there were a maximum of 133 possible scoring responses and these are broken down within the Standard into five distinct sections (Table 6). The results are also analysed according to this format. Many of the requirements are contingent upon holding a class of financial asset, liability or position e.g. requirements IFRS 7.9a through 7.9d are not applicable if the entity has not designated a loan or receivable as at fair value through profit or loss. Appendix D highlights those disclosures which are contingent upon the existence of a balance or position. To make this contingency issue clearer see appendix B for a detailed breakdown of one company’s disclosure compliance. This company, for example, has neither pledged nor holds collateral and therefore IFRS 7.14a & b (relate to collateral pledged) as well as IFRS 7.15a, b & c (relate to collateral held) are all marked ‘not applicable’. In addition, as discussed in section 4.4.1, the checklist requirements have been sub-categorised in the appendix between hard rules-based, soft rules-based and principles-based requirements and these classifications have been noted in appendix D.

The annual report of each company was reviewed manually to check the level of compliance with each disclosure question. Unlike some prior work, the scores were not weighted for quality (Toms, 2002; Hasseldine et al., 2005) because this would have introduced unnecessary subjectivity given the nature of the disclosure checklist questions, which are primarily binary outcomes. An unweighted scale was therefore adopted where ‘1’ signified compliance with the requirement, ‘0’ signified ‘does not comply’, and ‘N/A’, not required to comply.

At this stage, materiality potentially becomes a challenging concept however it is important not to exaggerate the level of, or reliance on, subjective judgement required from the coder to complete this exercise. The number of cases where coder subjectivity was called for were very few. Despite this, though one would like to believe that a coding process could be perfectly reproduced, this would in fact be extremely difficult (Krippendorff, 2004). In the majority of cases, when working through the disclosure checklist, one can either mark an item as ‘1’, ‘0’ or ‘N/A’ accordingly because the requirements are straightforward. However, there are occasions where an item might be deemed by an entity to be immaterial and
therefore no disclosure is provided. The coder is unaware of this decision not to disclose and therefore has to mark the checklist either ‘0’ or ‘N/A’. International Accounting Standard 1: Presentation of Financial Statements and the IFRS Framework (also known as the Conceptual Framework for Financial Reporting 2010) provides guidance on materiality by including a definition that reads (F QC11):

"Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity’s financial report." Thus, there is subjectivity in the interpretation of materiality however this definition provided was consistently applied throughout the coding process.

There were simple cases where omitted disclosures could be measured as required but not present according to a quantitative scale. For example, quantitative information should be provided where the value of an asset, liability, gain or loss are greater than 5% of profit before tax. However, there are areas where judgement becomes less formulaic. For example, when does one decide that an item of information is material by nature and thus should be disclosed? In many cases it is simply necessary to cede to the judgement of the company and mark the non-disclosure as ‘N/A’. However, before this notation was blindly recorded the financial statements were reviewed for evidence of supporting and corroborating evidence. For example, if a company provided no information about their management of market risk, the Operating and Financial Review was reviewed alongside any other likely triggers of market risk, for example commodities or derivatives trading, and assess whether this risk was material in nature. If sufficient evidence exists that this was purposeful non-disclosure then the registered result would be ‘0’ rather than ‘N/A’.

93 One interviewee (13) provided an interesting example of excluded information because of quantitative materiality which he believed was also not material by nature: “Say, looking at [our company] we have swaps that bring our debt back into relevant currencies as a sort of currency hedge, but the net effect of that is actually, we’ve taken out some swaps in a very different economic environment and actually we’re losing money week to week because we’ve locked into higher interest rates. Now you wouldn’t know that from reading our report, not material to the group, therefore we don’t need to beat ourselves up about it, but actually it was a poor decision in hindsight…. but it’s an odd thing because it’s nowhere to be seen, you know, you wouldn’t find that there, it’s not material so it doesn’t get caught by the materiality requirement.”
Further discussions of the measurements of quality are provided in Chapter 7. However, in terms of measuring quality by weighting the disclosure checklist is briefly considered here. One form of weighting would be to build on the recent strand of risk disclosure literature (see for example Bini et al., 2010, Dainelli et al.2008; Dainelli and Bini, 2011) and seek to weight the qualitative characteristics. This form of analysis carries more problems than it potentially solves, especially in the context of this study. Each of the qualitative characteristics is, in their own right, a nebulous concept and thus, providing clear, coherent and consistent definitions is complex and potentially variable. However, without these definitions it would be difficult to appraise disclosures, rank and weight accordingly. A weighted checklist on these grounds asks the associated and difficult question whether, in all situations, each qualitative characteristic is as important as any other. It would be difficult to defend a proposal that understandability, for example, is as important as the other characteristics given that the quantitative disclosures, particularly of derivatives, are often complex. As one analyst stated: “the thing is people stop trusting things when they do not understand them and therefore more complexity always appears with professionals in any industry as costless... but actually there’s an enormous cost to complexity which is that you just lose your customers... if you find yourself in a world where you’re not being trusted, this is a more broader social problem!” (interviewee 1)

However, this does not mean that the disclosure requirements are designed not to be understandable and this is not a redundant concept. Interviewee 7 argued: “I think if you read the [financial instruments disclosures] it gives you a feeling of the complexity of the business and to miss that I think would be an injustice as well, I think you should put those disclosures in just to give people a feel for, yes, you know what? It’s a complex business. And if shareholders are scared away by that or whatever, then maybe that’s not a bad thing, right? I think that’s better than making the business sound very simple and missing the important points and thinking that the business is simple.”

Thus, adopting a straightforward binary scale is more appropriate. In other words, either the information is present or it is not. If the IASB has deemed, after extensive consultation, that it should be, then it seems peculiar to weight the level of
importance of that information on these grounds. In addition, the model attracts too much speculation, especially when one starts adding weight to the fundamental concepts of relevance and fair representation, and less weight to the supporting characteristics of understandability, comparability, verifiability and timeliness.

A second weighting approach one could adopt would be to weight for qualitative information versus quantitative information. This system has been adopted in various forms, but most notably established and developed in the field of intellectual capital disclosures. Guthrie and Petty (2000) designed a coding framework where they gave a value of ‘0’ if the disclosure (associated with one of their 19 key variables) was not provided in the annual report, ‘1’ if the disclosure was presented in a discursive way, ‘2’ if the information was quantified, and ‘3’ if the information was evaluated in dollars. Bozzolan et al. (2003: 549) built on this system and coded each sentence with a score of ‘0’ if a company provided no information, a score of ‘1’ if a company provided qualitative information and finally, with a score of ‘2’ if the company provided supporting quantitative information.

A similar system has been used in the field of environmental and social disclosures, but the purpose and design of the measurement model has been with a different accent. Many of these studies work on the basis that quantitative and monetary information is more informative than qualitative information (see for example Aerts, Cormier and Magnan, 2008; Cho and Patten, 2007; Al-Tuwaijri, Christensen and Hughes II, 2004; Milne and Patten, 2002). Recently, a study by Cormier et al. (2009) formally tested this assumption by adopting a weighted scale for quantitative and qualitative information and claimed to substantiate the assertion.

A weighted scoring system appears to have significant benefits; however, the positives of this system would be outweighed by the negatives and would not benefit this study. Information requirements in a mandatory scenario are frequently rules-based (57 hard rules; 47 soft rules; and 29 principles) and therefore the information should either be provided (1) or not (N/A). The third alternative is that the information should be provided and is not (0). A more elaborate scoring system risks introducing

---
94 For example this is potentially a more precise measure of compliance and thus could serve to simplify a ranking of information process.
unnecessary subjectivity and provide a ranking system based upon the coders information preferences. In fact, where there is some form of additional qualitative and/or quantitative information, then one should consider why this is being provided. There is the possibility that instead of facilitating the easement of the information asymmetry gap, this information might serve to obfuscate or mislead (see Chapter 5 for more details). In addition, the qualitative disclosures are not always the most useful as explained by interviewee 2 who commented that “there’s a bundle of narrative [IFRS 7 disclosures]... but I would not expect any investor to be surprised at all by what they read... they should be reading it and go, yes, yes, yes, yes, I know all that”.95

In addition to these prior studies, Tsalavoutas et al. (2010) have produced a study assessing the two extant mandatory disclosure compliance methods: the dichotomous method; and the ‘partial compliance unweighted method’. The key finding of this paper is that the two methods produce significantly different compliance results. The underlying theme to the argument is that a scoring system should not weight according to the number of requirements of a standard over another standard – i.e. one set of disclosures should not carry a greater weighting purely because it has a greater number of requirements. This is not relevant to this study as only IFRS 7 is being considered.

However, if one chooses to extrapolate this argument then it could be considered that there are some disclosures within IFRS that are given a disproportionate weighting because there are more associated requirements. This problem is much harder to overcome because it is true. To address this issue, not only are the headline compliance scores presented but this study also highlights those areas where systemic weaknesses (partial or non-compliance) were found. Furthermore, this study then extends to an analysis of these compliance issues on a case-by-case basis.

95 This view was not shared by everyone. One interviewee and preparer of the disclosures (interviewee 12) thought that the narrative disclosures were important because they were simple and because one didn’t have to be a sophisticated investor them. He argued that “the tables don’t necessarily give much to, unless they’re sophisticated investors, but the words do.” He added the caveat that he felt the auditors needed to review the narrative to ensure that the story was consistent and truthful.
Content analysis research has recently been categorised according to the two generic approaches that Smith and Taffler (2000: 627) outlined: ‘form-oriented’ and ‘meaning oriented’. The former relates to measuring the quantity of words whilst the latter focuses on the underlying themes in the observed texts. This study falls between these two stalls. Cases of partial or non-disclosure were identified, or in content analysis terms, a lack of quantity. Subsequently an underlying rationale has been focused on. With the exception of Lundholm and Van Winkle (2006), there is no other study that has attempted to answer this question and none which provides empirical evidence of this type.

The FTSE 100 non-financial IFRS 7 compliant companies were analysed as at 13 October 2008. In total, 66 companies were reviewed for the purposes of this study. Of the FTSE 100, 12 companies had not yet adopted IFRS 7 for the first time due to the timing of their year-ends, and the remaining 22 were financial companies. A small number of companies have voluntarily disclosed information over and above the requirements of IFRS 7, and this data has been analysed in Chapter 5.

The coding was undertaken by one person, which is often cited as a hedge against the typical reliability issues associated with content analysis – stability, accuracy and reproducibility (Krippendorff, 2004). However, in order to further address any potential problems, two experts in financial reporting undertook a coding exercise for 10 of the sample companies. Kappa coefficients for inter-coder reliability ranged from $\kappa = 0.97$ to $\kappa = 1.00$. Thus, the results of this sensitivity analysis indicate that the results of the coding exercise are robust. There will always be an element of subjectivity and there are no guarantees of achieving identical results if one replicated the study. Weber (1990: 62) stated this issue in other words when he put forward the argument that “interpretation (of text) is in part an art”.

As part of this project a series of interviews were conducted. For a more detailed review of the method and approach see Section 6.3.1. The interviews produced data which was relevant to discussions within the findings sections for this chapter and

---

96 Amendment to IFRS 7 for disclosures relating to reclassifications of financial assets – effective date 1 July 2008 but released in October 2008.
97 See Milne and Adler (1999) for further discussions of this coding reliability issue.
therefore appendix E contains some information both about the interviewees and the interview instrument adopted. In brief, these were semi-structured interviews and were conducted with key stakeholders related to the financial instruments disclosures of the sampled entities.

4.4 Results

As shown in Table 6, IFRS 7 is divided into five distinct disclosure sections: Balance Sheet; Income Statement and Equity; Other Disclosures; Nature and Extent of Risks; Adoption and Exemptions. These sections are then further subdivided. To enhance readability the results of this study are presented in a way that is consistent with this pattern. Preceding this is a brief overview of the compliance results split between rules-based and principles-based requirements.

In total, the checklist had a maximum of 133 returnable results; however, the maximum available score after N/A entries for any single company in the sample was 98, the minimum was 61 and the mean was 76. The mean overall compliance result was 94%. This is significantly higher than that found by prior studies. However, it should be noted that: firstly, this should be 100%; and secondly, this hides areas of weakness.
Table 6: Breakdown of checklist questions between the five categories of disclosures mandated by IFRS 7

<table>
<thead>
<tr>
<th>Categories</th>
<th>Number of questions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(1) BALANCE SHEET</strong></td>
<td></td>
</tr>
<tr>
<td>Categories of financial assets and financial liabilities</td>
<td>8</td>
</tr>
<tr>
<td>Financial assets or liabilities at fair value through profit or loss</td>
<td>8</td>
</tr>
<tr>
<td>Reclassification</td>
<td>3</td>
</tr>
<tr>
<td>Derecognition</td>
<td>4</td>
</tr>
<tr>
<td>Collateral</td>
<td>5</td>
</tr>
<tr>
<td>Allowance account for credit losses</td>
<td>1</td>
</tr>
<tr>
<td>Compound financial instruments with multiple embedded derivatives</td>
<td>1</td>
</tr>
<tr>
<td>Defaults and breaches</td>
<td>4</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>34</strong></td>
</tr>
<tr>
<td><strong>(2) INCOME STATEMENT AND EQUITY</strong></td>
<td></td>
</tr>
<tr>
<td>Items of income, expense, gains or losses</td>
<td>10</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>10</strong></td>
</tr>
<tr>
<td><strong>(3) OTHER DISCLOSURES</strong></td>
<td></td>
</tr>
<tr>
<td>Accounting policies</td>
<td>10</td>
</tr>
<tr>
<td>Hedge accounting</td>
<td>12</td>
</tr>
<tr>
<td>Fair value</td>
<td>16</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>38</strong></td>
</tr>
<tr>
<td><strong>(4) NATURE AND EXTENT OF RISKS ARISING FROM FINANCIAL INSTRUMENTS</strong></td>
<td></td>
</tr>
<tr>
<td>Qualitative disclosures – credit risk</td>
<td>6</td>
</tr>
<tr>
<td>Quantitative disclosures – credit risk</td>
<td>1</td>
</tr>
<tr>
<td>Qualitative disclosures – liquidity risk</td>
<td>6</td>
</tr>
<tr>
<td>Quantitative disclosures – liquidity risk</td>
<td>1</td>
</tr>
<tr>
<td>Qualitative disclosures – market risk</td>
<td>6</td>
</tr>
<tr>
<td>Quantitative disclosures – market risk</td>
<td>1</td>
</tr>
<tr>
<td>Quantitative disclosures – other risks</td>
<td>4</td>
</tr>
<tr>
<td>Further credit risk disclosures</td>
<td>9</td>
</tr>
<tr>
<td>Further liquidity risk disclosures</td>
<td>8</td>
</tr>
<tr>
<td>Further market risk disclosures – Sensitivity analysis</td>
<td>7</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>49</strong></td>
</tr>
<tr>
<td><strong>(5) ADOPTION AND EXEMPTIONS</strong></td>
<td></td>
</tr>
<tr>
<td>Early adoption</td>
<td>1</td>
</tr>
<tr>
<td>Exemption from preparing comparative information</td>
<td>1</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>2</strong></td>
</tr>
<tr>
<td><strong>TOTAL MAXIMUM RETURNABLE CHECKLIST RESULTS</strong></td>
<td><strong>133</strong></td>
</tr>
</tbody>
</table>
As with prior studies it was found that the disclosures were spread throughout the annual report; however these were presented consistently from one company to the next and adequately signposted. A point made by several interviewees was that these disclosures are intended for sophisticated users of the financial statements, especially the derivatives led quantitative disclosures. Specifically one treasury director stated: “unless you are truly sophisticated about your understanding of the fair value of derivatives I don’t think you have a clue about what the reports are saying in reality.” (interviewee 12)

There are two major frustrations from a reader’s perspective which are: some disclosures, particularly those of a narrative or descriptive nature, were occasionally cross-referenced to the front-end of the annual report; and if one had a specific issue or enquiry, it would be difficult to find that item amongst what is a vast amount of other information. Regarding this latter point, interviewee 5 stated: “I think [the financial instruments disclosures] have big understandability but when you want to get detailed information... but the problem is maybe when you just want to look for some special kind of aspects, OK...you have to be maybe an accountant or have some specialised knowledge”.

In addition, a point stressed by each of the analysts who were interviewed was that they, and their colleagues, were under significant time pressure and though they felt that some of this information was important they also stated that they were concerned that they were not giving the key information enough attention. Interviewee 1 revealed: “the truth is that most of the time I don’t look at it all”. Instead he said he focused on the last six months trading and then investigated the disclosures in areas where the company “has been exposed as being rather inadequate”. He reported that he’d been “having a conversation with a company last week where [he] was asking some questions about how something works and they sort of said oh, well did you look in note X sort of thing... and well... no, I didn’t”. Also illustrating this point was another comment from an analyst (interviewee 14): “It’s only a risk, it’s not an opportunity, so for the vast majority of companies that I follow, for example, it isn’t an issue. At least I hope it isn’t, but it might be, but I haven’t got
the time to find out whether it is or it isn’t”. One interviewee said that if the information was overly dense, complex or was deemed to be “contaminating other information” then he would simply separate it out, “black box it... and add on risk premia” (interviewee 8). Interviewee 4 argued a similar point when he said: “the whole thing could blow up overnight because of these instruments... so we know that could happen and we have to take a view, and the view is to reverse out those instruments in many cases and set them out separately and then essentially add them into our risk profile of the business... you’ve got to watch out for these horrible things.”

Also of some concern was that two of the analysts, who were both senior and share over 40 years experience between them, stated that they had fundamental concerns that junior colleagues ignored much of the annual report – he especially listed complex accounting issues such as pensions, deferred tax and financial instruments – because of a lack of experience and time. Interviewee 4 went on to say about new recruits: “in the big banks particularly they are largely hired for their marketing skills... as opposed to their analytical skills, or at least the marketing skills are judged more valuable per se than their pure analytical skills. So I think there are three factors that contribute to people choosing to ignore standards they don’t fully understand, whereas my attitude is if I don’t understand it, then there’s probably a damn good reason that I need to understand it.”

This project is not exclusively about derivative financial instruments however when entities engage in derivatives based risk management there are significant associated disclosures. Therefore, a brief summary of companies’ derivatives usage and the types of risks being managed serves to set this project in context. In addition, it serves to highlight that these entities, though generally looking to achieve the same ends, are not all engaging in perfectly comparable usage. Only one firm declared that they do not use derivative financial instruments (Kazakhmys). Instead they claim to engage in natural or operational hedging practices allowing investors, according to the annual report, to “fully participate in price movements through the

---

98 Many of the interviewees stated some level of dissatisfaction about over-regulation but it is worth noting that interviewee 8 was extremely outspoken about the failings of the standard setters and the “tyranny of Tweedle” in particular.
99 He added the changing environment to time and experience.
commodity cycle”. There are a number of entities that engage heavily with derivatives usage and these are, by and large, the oil and gas extractors. The company with the largest exposure to both derivative assets (£20,005 million) and derivative liabilities (£20,637 million) during the period under review was Royal Dutch Shell. However, to a larger or lesser degree every other entity has some level of reliance on derivatives to manage risk and their disclosures make it clear that their operations and earnings streams would be exposed to greater volatility without them. On average this sample of companies held derivative assets to the value of 4.3% of their total assets at the end of the reporting period. To emphasise this point, only 10 companies (one of whom was the aforementioned Kazakhmys) had an exposure of less than £10 million in terms of either derivative assets or derivative liabilities at the end of their financial year on commencing on or after 1 January 2007. These entities averaged £1.9 million of derivative assets on their balance sheets and £3.6 million of derivative liabilities.

The average level of derivative asset carried on the balance sheet during the period for the sample was £707.8 million and the average level of derivative liability was £700.3 million. A wide range of derivative financial instruments is reportedly used including swaps, swaptions, forwards, futures, options (and collars) plus embedded derivatives (see table 7). As it is not required, not all companies presented derivatives positions disaggregated by instrument (some chose instead to disaggregate by risk type or by their maturity split between current and non-current). However, working from the disaggregated data that was presented, the most popular instruments being used were forwards and futures (29.7% of assets; 41.0% of liabilities), swaps (16.2% of assets; 8.9% of liabilities), and then options (5.2% of assets; 0.0% of liabilities).

In addition, entities attempted to hedge against a broad range of risks. Specifically mentioned by these companies were interest rate risks, foreign exchange risks, market risks (including commodity price risk and equity related risk) (see table 1 and appendix A for further analysis). Approximately 13.5% (7.6%) of derivatives being carried as assets (liabilities) were used to manage foreign exchange risks; 16.5% (9.4%) of assets (liabilities) were used to manage interest rate risk or foreign denominated borrowing risks; 65.4% (76.1%) were used to manage market risks e.g.
commodity price volatility; and the remaining 4.7% (6.9%) managed other exposures or it was not possible to discern the risk being managed as the information was not provided.

Table 7: Analysis of derivative financial instruments for the sample (by risk managed and type)

<table>
<thead>
<tr>
<th>Risk Type</th>
<th>£ million</th>
<th>%age of total derivative assets</th>
<th>%age of total derivative liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Foreign exchange risk</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forwards and futures (assets)</td>
<td>3,134.6</td>
<td>6.6%</td>
<td></td>
</tr>
<tr>
<td>Forwards and futures (liabilities)</td>
<td>(3,005.7)</td>
<td>6.4%</td>
<td></td>
</tr>
<tr>
<td>Options (assets)</td>
<td>2,479.0</td>
<td>5.2%</td>
<td></td>
</tr>
<tr>
<td>Options (liabilities)</td>
<td>0.0</td>
<td>0.0%</td>
<td></td>
</tr>
<tr>
<td>Instruments not disaggregated by type (assets)</td>
<td>763.2</td>
<td>1.6%</td>
<td></td>
</tr>
<tr>
<td>Instruments not disaggregated by type (liabilities)</td>
<td>(556.8)</td>
<td>1.2%</td>
<td></td>
</tr>
<tr>
<td><strong>Interest rate risk</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Swaps (assets)</td>
<td>2,742.4</td>
<td>5.8%</td>
<td></td>
</tr>
<tr>
<td>Swaps (liabilities)</td>
<td>(1,538.8)</td>
<td>3.3%</td>
<td></td>
</tr>
<tr>
<td>Swaptions (assets)</td>
<td>0.0</td>
<td>0.0%</td>
<td></td>
</tr>
<tr>
<td>Swaptions (liabilities)</td>
<td>(6.0)</td>
<td>0.0%</td>
<td></td>
</tr>
<tr>
<td>Collars (assets)</td>
<td>0.0</td>
<td>0.0%</td>
<td></td>
</tr>
<tr>
<td>Collars (liabilities)</td>
<td>(2.3)</td>
<td>0.0%</td>
<td></td>
</tr>
<tr>
<td>Instruments not disaggregated by type (assets)</td>
<td>148.3</td>
<td>0.3%</td>
<td></td>
</tr>
<tr>
<td>Instruments not disaggregated by type (liabilities)</td>
<td>(212.2)</td>
<td>0.5%</td>
<td></td>
</tr>
<tr>
<td><strong>Cross currency risk e.g. swaps</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps (assets)</td>
<td>4,902.8</td>
<td>10.4%</td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps (liabilities)</td>
<td>(2,651.0)</td>
<td>5.7%</td>
<td></td>
</tr>
<tr>
<td><strong>Market risks e.g. commodities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market risks e.g. commodity price risk - forward commodity contracts (assets)</td>
<td>10,933.7</td>
<td>23.1%</td>
<td></td>
</tr>
<tr>
<td>Market risks e.g. commodity price risk - forward commodity contracts (liabilities)</td>
<td>(16,204.9)</td>
<td>34.6%</td>
<td></td>
</tr>
</tbody>
</table>
Instruments not disaggregated by type (assets) 19,994.9  42.3%
Instruments not disaggregated by type (liabilities) (19,422.6)  41.5%

**Equity/capital related instruments**
Equity risk related instruments including collars, options and warrants (assets) 41.5  0.1%
Equity risk related instruments including collars, options and warrants (liabilities) (131.6)  0.3%

**Embedded derivatives**
Embedded derivatives (assets) 259.6  0.5%
Embedded derivatives (liabilities) (32.0)  0.1%

**Unclassified / other**
Instruments where asset type not provided (assets) 1,870.6  4.0%
Instruments where asset type not provided (liabilities) (2,955.7)  6.3%

Instruments not disaggregated:
  - Currency and commodity contracts (assets) 34.0  0.1%
  - Swap and forward exchange contracts (assets) 8.2  0.0%
  - Interest rate swaps and forward foreign exchange contracts (liabilities) (97.8)  0.2%
  - Swap and forward exchange contracts (liabilities) (2.8)  0.0%

Information source: annual reports for years commencing on or after 1 January 2007

4.4.1 Rules-based versus principles-based accounting standards

Primarily as a result of a series of accounting scandals, including Enron and WorldCom, the financial reporting community re-raised concerns about the prescriptiveness of accounting standards (Nobes, 2005). In response the US FASB issued a proposal document (2002) entitled *Principles-based approach to US standard setting*. Therein the FASB re-iterated the underlying objective of financial information – to provide decision useful information (p.1) – in addition to outlining key concerns about the extant ‘rules-based’ reporting system in relation to the achievement of this objective. The argument put forward was that a principles-based approach could improve the “*quality and transparency of financial accounting and reporting*” (p.1). This point was reiterated during several interviews and though the majority felt that rules-based requirements were necessary for encouraging the
production of useful information, one interviewee (5), strongly agreed: “I think sometimes it would be better to be more principles-based, to have a more principles-based approach... and thus reduce the [number of] requirements for the standards”. This argument echoes that put forward by the authors of the recent joint ICAS / NZICA report (2011) into over-complexity in the annual report as discussed in section 1.1.2,

It was commented by FASB (2002) that a rules-based system had made accounting standards increasingly complex and detailed. Even though the standard setters were responding to demand, the FASB argued that as a result of the rules-driven reporting process, organisations would be able to engineer their accounting and to “structure transactions ‘around’ the rules” (p.2, FASB emphasis). In addition, FASB raised the point that a rules-based system facilitates the risk that accounting and auditing could simply become a ‘tick box’ (or ‘check box’) process and thus the quality of information would be damaged (FASB, 2002; Schipper, 2003).

There have been divergent opinions not only about the definitions of rules and principles in an accounting context but also about whether the US accounting system is actually rules-based or rather whether the standards are “based on principles... but also contain elements... that make them appear to be rules-based” (Schipper, 2003: 71). Equally commentators speculate over whether international standards, often viewed as principles-based standards, are more rules-based than they are thought to be (e.g. Bennett et al., 2006). The purpose of this project is not to investigate ‘why’, or indeed ‘whether’, the US has a tendency towards a rules-based process or to offer an authoritative view on whether it is a better system. Instead, this work attempts simply to analyse whether compliance levels differ between rules-based requirements and principles-based requirements and whether any general conclusions can be drawn from this analysis. Thus, by providing evidence in this regard, this work will contribute to this debate by adding empirical compliance based evidence in relation to a disclosure standard.

Alexander (1999: 240) sought to outline the nature of principles and rules. He derived the following classification system and argued that there were three broadly defined approaches:
• “Type A – A generally expressed all-pervasive fundamental concept.
• Type B – A set of rules, conventions or ways of thinking which are to be consistently applied to situations both familiar and unfamiliar.
• Type C – The detailed provision of specific methods for the treatment of all expected problems and situations.”

Alexander’s type A (e.g. true and fair view) and type B criteria (e.g. prudence) can be classified as principles whilst the type C description outlines rules. Or, as Alexander noted, “type C criteria will normally provide a convenient day-to-day checklist for defining the adequacy of financial statements” (p.240). In addition, Nelson (2003: 91) includes within the definition of rules “specific criteria, ‘bright line’ thresholds, examples, scope restrictions, exceptions, subsequent precedents, implementation guidance, etc.” These definitions remain broadly consistent with those applied in this study as well as those employed by prior research (e.g. Schipper, 2003; Nobes, 2005; Bennett et al., 2006; Benston et al., 2006).

In addition, it should be noted that Bennett et al. (2006) proposed a sub-categorisation of rules stating the belief that there are various levels and types of rule. They argued that there are hard rules and soft rules as well as hard ‘bright lines’ and soft ‘bright lines’.100 Hard rules provide guidance as to what is permissible in advance whereas soft rules require judgement to be employed. This sub-categorisation seems particularly appropriate given the levels of judgement required by many of the IFRS 7 requirements and thus this further distinguishing factor is added to the analysis.

Many of the IFRS 7 requirements are not strictly (according to the above definitions) type A or B requirements however, one of the key arguments against rules-based accounting is that it restricts the employment of professional judgement (e.g. FASB, 2002; Schipper, 2003; Nobes, 2005). Therefore, for the purposes of this project, the requirements of IFRS 7 have been analysed into three categories: principles-based requirements (type A or B); soft rules requirements (type C judgements); and hard

100 IFRS 7 contains no ‘bright line’ thresholds and therefore this is discussed no further and plays no role in the categorisation of requirements.
rules requirements (type C conduct defined in advance). An analysis of the compliance checklist and this categorisation can be seen in appendix D. The results can be seen in table 8 below (in addition, a full analysis [by company] is presented in Appendix B).

Table 8: Rules-based versus principles-based disclosure summary

| Number of rules-based (hard) categorised requirements | 57.0 |
| Mean maximum score availability                      | 31.7 |
| Mean score                                           | 30.6 |
| Standard deviation from mean                          | 4.4  |
| Median score                                         | 31.0 |
| Mean compliance percentage                           | 96.5%|
| Standard deviation from mean compliance              | 5.3% |

| Number of rules-based (soft) categorised requirements | 47.0 |
| Mean maximum score availability                       | 21.5 |
| Mean score                                           | 20.2 |
| Standard deviation from mean                          | 4.4  |
| Median score                                         | 20.0 |
| Mean compliance percentage                           | 93.9%|
| Standard deviation from mean compliance              | 7.6% |

| Number of principles-based categorised requirements   | 29.0 |
| Mean maximum score availability                       | 22.8 |
| Mean score                                           | 21.0 |
| Standard deviation from mean                          | 2.4  |
| Median score                                         | 21.0 |
| Mean compliance percentage                           | 91.9%|
| Standard deviation from mean compliance              | 8.4% |

As the table above shows, there were 57 hard rules-based requirements that firms could potentially fulfil dependent upon their financial instruments usage, position and performance. However, after adjusting for ‘N/A’ results, the average number of requirements a firm must comply with for the sample in this study was 32. The soft rules-based requirements numbered 47 and after adjustments this led to an average maximum of 22 across the sample. The number of principles-based requirements was 29 with an average maximum of 23 again after making the necessary adjustments.
adjustments for N/A results. Though this is the first study to sub-categorise between hard and soft rules requirements, the split between rules and principles is similar to prior studies (e.g. Bennett et al., 2006\textsuperscript{101}).

The results suggest that as the level of judgement required becomes greater, the level of compliance decreases. Soft rules requirements carry a mean compliance of 93.9\%, 2.6\% lower than hard rules requirements (96.5\%). Compliance with principles-based requirements drops again by a further 2\% to 91.9\%. It should be noted that the compliance levels remain high regardless of this difference between compliance between the type of requirement. In addition, each of the three categories of compliance result – hard rules, soft rules and principles – show a strong positive correlation. The correlation between the hard rules compliance percentage and soft rules compliance percentage is 0.659; the correlation between hard rules compliance and principles is 0.453; and the correlation between soft rules compliance and principles is 0.396. The findings presented in this chapter highlight those areas where this distinction between rules-based requirements compliance failings and principles-based requirements failings is of potential significance to the analysis. A brief preliminary analysis follows.

At this stage of the analysis, before the more detailed observations regarding areas of full, partial and non-compliance, it is worth highlighting some general points and to draw attention to a few of the significant differences in compliance on a company-by-company basis. British Energy is the only firm with a significantly lower compliance with hard rules than soft rules and principles-based requirements. As a naive observation one could argue that it would seem unsurprising that there are not more examples of this given that the hard-rules requirements are predominantly ‘tick-box’. The underlying rationale for the non-compliance is unknown however in real terms, the percentage compliance was high and even though compliance with hard-rules based requirements has been highlighted, the compliance result within this category still amounted to 87.1\% which equated to the firm correctly responding to 27 of 31 requirements. Three of the requirement compliance failings arose in relation to the provision of information regarding cash flow hedging. It would be difficult to argue

\textsuperscript{101} According to Bennet et al. (2006) SFAS 2 had 52\% rules, IAS 9 had 80\% rules and FRS 13 had 83\% rules. According to the analysis above, IFRS 7 had 78\% rules-based requirements.
that materiality justified the withholding of this information given that it is sensitive in nature and also in terms of size given that the firm made losses of £102 million in relation to cash flow hedges during the year (against profits before taxation of £538 million). There is the chance therefore that this is evidence of impression management however, given that the disclosure decision is private, this information might not be withheld but rather simply excluded due to preparation error and audit oversight.

Five entities showed significantly lower compliance results related to soft rules based requirements than hard-rules based requirements. One pattern that emerged was that in four of these cases, firms have not provided a full detailed analysis of their impaired assets. It could be argued that the value change might be deemed immaterial by the entity. In addition, neither G4S nor Tullow Oil have provided full information in their accounting policies specifically about their assets classified as fair value through profit or loss. Again, by way of explanation, in the case of G4S, the values of these assets may be deemed immaterial and the exposure to risks arising from derivative financial instruments for the entity is relatively small especially in comparison to other firms (with G4S showing a total holding of derivative assets of £17.4 million and derivative liabilities of £21.8 million against total assets: £3,675.8 million [i.e. 0.5%]; and total liabilities: £2,552.8 million [0.85%]). In the case of Tullow Oil, the disclosures need to be provided because even though there are no assets or liabilities categorised as fair value through profit or loss in 2007 there are significant assets categorised as such in the previous year. Both Smith and Nephew and Tullow Oil referenced assets which had been valued subject to a measure which was not obtained via reference to an open market and explanations of this issue were deemed inappropriate by the coder. Ultimately the standard requires the preparer to allow users to assess any potential differences that might arise between valuation techniques [IFRS 7.29-30] and in the absence of information this is not possible.

102 For example, the value change for impairment is as low as 0.5% of profits before taxation for Diageo and as high as 4.9% of profits for G4S. This equates to 0.1% and 0.2% of revenue and in the case of Diageo and G4S respectively.
103 It should be noted that although there were no assets or liabilities held categorised as fair value through profit or loss in the year to 31 December 2007 there were associated profits and losses for both 2006 and 2007.
There were several compliance issues that arose from a principles-based requirements perspective. These can be broadly grouped and explained as primarily arising where firms failed to outline the underlying rationale (when IFRS 7 required this disclosure) for categorisation which would be consistently applied (for example an explanation of when an entity would categorise an asset or liability as available for sale) or where an entity was required to provide criteria which would be applied in the past, current and future periods. As an example, many entities produced incomplete sensitivity analysis information and did not disclose the methods and assumptions applied when carrying out this analysis when required to do so. In addition, a small number of companies provided incomplete qualitative information related to the nature of the risks arising from their financial instruments and how these would be managed.

4.4.2 Balance sheet disclosures

Table 9 summarises the level of compliance with the mandatory balance sheet disclosures. As discussed earlier, theoretically the disclosure levels should be high, particularly given the specific nature of many of the balance sheet questions, which simply required quantitative responses. Of the total 34 balance sheet disclosure requirements, 19 were hard rules-based, 14 soft rules-based and only one was a principles-based requirement104.

The high levels of compliance are consistent with the presumption put forward earlier of high management and auditor quality combined with the sensitive nature of these disclosures and thus the potential for significant litigation costs and reputational damage if information were to be misrepresented or misreported.

104 Of which no entity prepared a response on the basis that no “entity believed that the disclosure they gave to comply with the requirements in para 9(c) or 10(a) of IFRS 7 did not faithfully represent the change in the FV of the financial asset or liability attributable to changes in credit risk” [IFRS 7.11b].
Table 9: Balance sheet financial instruments disclosure
(IFRS 7.8–7.19)

<table>
<thead>
<tr>
<th>Category</th>
<th>nq</th>
<th>Nf</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Categories of financial assets and financial liabilities (Categories)</td>
<td>8</td>
<td>66</td>
<td>99%</td>
</tr>
<tr>
<td>Financial assets or liabilities at fair value through profit or loss (FV through PL)</td>
<td>8</td>
<td>65</td>
<td>97%</td>
</tr>
<tr>
<td>Reclassification</td>
<td>3</td>
<td>12</td>
<td>88%</td>
</tr>
<tr>
<td>Derecognition</td>
<td>4</td>
<td>6</td>
<td>100%</td>
</tr>
<tr>
<td>Collateral</td>
<td>5</td>
<td>49</td>
<td>99%</td>
</tr>
<tr>
<td>Allowance account for credit losses</td>
<td>1</td>
<td>56</td>
<td>89%</td>
</tr>
<tr>
<td>Compound financial instruments with multiple embedded derivatives</td>
<td>1</td>
<td>23</td>
<td>100%</td>
</tr>
<tr>
<td>Defaults and breaches</td>
<td>4</td>
<td>2</td>
<td>100%</td>
</tr>
</tbody>
</table>

Note: nq = maximum number of compliance questions applicable to that section; nf = Number of firms with required disclosure

There were minor instances of non-compliance related to the hard rules-based dominated Categories of financial instruments (IFRS 7.8) and soft rules-based FV through PL (IFRS 7.9–11) disclosure requirements. These were either financial reporting inaccuracy or audit failure, predominantly where figures were irreconcilable and where there were cases of figures being reported differently from one note to the next. One company, for example, disclosed a different maximum exposure to credit risk for a loan held as FV through PL (IFRS 7.9a) at the reporting date in two separate notes. It might be argued that this is evidence of intentional obfuscation but given the immaterial difference, it seems highly unlikely that this was deliberate.

Only one company, Enterprise Inns, did not present gains or losses arising from financial instruments at FV through PL. Every other company in the sample either holds financial liabilities at FV through PL or/and they hold derivatives not held in hedge accounted relationships. By classifying instruments into this category, it is likely to provide sophisticated users information that might alert them to potential exposure to financial instruments-driven volatility in their income statements, as fair value gains and losses will be recognised on these assets and liabilities immediately.
and not deferred. It is comforting to note that despite the potential for this not to be costless this information has been fully disclosed with no observed errors.\footnote{An argument put forward by a financial controller (interviewee 11) was that companies should be producing this information. If they are not then it would be costly to prepare but, he argued, it would be more costly not to have this information to hand. In response to the claim that this information might be costly to prepare he argued: “if you do it at least once a year I think it’s better than not doing it at all. If you’re talking a huge company and if they don’t do this on a regular basis, at least once a quarter, I would be worried, I would be very worried, unless of course they don’t have borrowings, they only deal with one market, in one country, they never exchange currency. But if we’re talking a huge multi-national group that is not going to be the case and most people have borrowings, and I can’t see any CEO or FD not wanting to know this type of information”. Interviewee 10 echoed these sentiments and went one further by suggesting: “we’ve got a whole floor of finance people, but they’re all in individual teams, they don’t necessarily ever talk to each other, you’re effectively having to cross-pollinate one series of disclosures and taking bits from everyone, and in a way they all have to be together because we have set timelines for reporting, and even though this is only probably a once or twice a year thing for us, I think the opinion from the guys that were doing it, I think they actually quite enjoyed getting involved with it and were talking about running it quarterly anyway, just for internal purposes. And I kind of hope that it does get built into our kind of quarterly system, I don’t think it’s necessarily going to be any more work because it’s all information that already exists. Hopefully... it’s a nice way of collating it together and will find kind of a strategic purpose.”}

Both preparers and analysts who were interviewed agreed that the headline balances (i.e. assets and liabilities, gains and losses) were important to an analysis of the performance and position of the firm. However analysts argued that the location and interpretation of some of the gains and losses was made overly difficult from the perspective of calculating the level of smoothing, particularly those related to hedging instruments (and differentiating between hedging instruments and derivatives not used for hedging). Interviewee 8, for example, stated: “\textit{trying to locate where on earth they [the derivatives and associated gains and losses] appear in the accounts, in the balance sheet, whether it’s in... is it in at fair value, is it in the statement of equity or cash flow, hedging, in the other thing – ah! You just cannot latch on.”

Twelve companies have reclassified financial instruments, but the disclosures required (IFRS 7.12) were deemed to be fully appropriate in ten cases. The remaining two cases were judged, on balance, not to have met the full requirement (Anglo American and Home Retail Group). In one case the reclassification is made but not fully documented in the audited section of the financial statements, and in the other it was observed from the notes to the financial statements that a reclassification had taken place, but there was no narrative explanation and the measurement method is unclear. It is difficult to ascertain why these disclosure
requirements have only been partially met. Reclassifications constitute proprietary information, and thus the conceptual framework presented as figure 1 asks us to consider whether the potential losses arising from non-disclosure might be greater than the costs of full disclosure. This is unlikely to be the case as a regulatory intervention would probably constitute asking for a restatement in the first instance and then if agreement was not found, in the worst case scenario, a fine could be pursued through the courts if the restatement was not made.\textsuperscript{106} Therefore, in the absence of a more likely explanation one is left to consider the possibility that in the eyes of management this information lacks usefulness and has been omitted and there has been a subsequent audit oversight.

The majority of companies in the sample (74\%) either held collateral or reported having pledged financial assets as collateral. All of those who had pledged collateral adequately disclosed this in accordance with IFRS 7. Of those companies who held collateral, two companies (Enterprise Inns and Liberty International) failed to note the terms and conditions associated with its use. It was deemed by the coder that the information produced by Liberty was overly dense, lacked narrative quality and was confusing. Thus it was deemed inadequate due to its lack of usefulness. Given the fact that the disclosure is present balanced against the manner in which it is presented and the potential sensitivity of that information\textsuperscript{107}, the disclosure could potentially be attributable to a desire to engage in obfuscatory behaviour. Equally however, this lack of uniformity is a reported effect of first-time adoption and the lack of a pro-forma example or boiler-plate disclosures means that there is likely to be some information which might not be perfectly presented. When one looks at

\textsuperscript{106} The FRRP have never taken any compliance related issue to court as at September 2011 (See www.frc.org.uk for details of the settlement of cases).

\textsuperscript{107} Pledging assets against obligations can be seen as a sensitive issue. See for example the case of Greece’s current debt crisis. The Prime Minister, George Papandreou argued that “one thing on which we [Greece] are very sensitive: to ask us for an island or a monument as a guarantee is nearly an insult.” He said, “Greece’s islands will not be used as collateral.” (Stewart and Clark, 2011).

Disclosures of collateral was noted by comment letter respondents as a sensitive issue and one which attracted the following criticisms: further clarification required (1 comment); difficulties in calculating fair value (8 comments); inconsistency between IFRS definitions in relation to collateral (3 comments); problems associated with master netting agreements (5 comments); clearer guidance over narrative required (2 comments); it would cost more to produce than the benefits that would be created (15 comments); disclosure would be misleading (6 comments); it was impractical to produce (9 comments); other issues (10 comments).
Liberty’s derivatives gains/losses during the year there is no reason to believe they have anything to hide or obfuscate.108

The issue of information overload and providing excess information to be deliberately obfuscatory is one which some analysts fundamentally disagree. Though there were many references to there being too much detail – which echoes the recent discussions amongst standard setters and professional bodies (e.g. ICAS, 2010; FRC, 2009, 2011) – it was interesting that one analyst (interviewee 4) argued: “what I really want is a much fuller disclosure of the mechanics of the instrument, so that might go right down to providing me with a pricing formula if used... now this of course would make vast reams of detail on the background of the report and accounts and a lot of analysts have a problem with that already, saying that there’s already too much to get through... and therefore it’s not a good commercial use of time. But I have to disagree fundamentally with that position”.

The other non-compliant company, Enterprise Inns, stated that the collateral held was in the form of cash and there was no indication as to the conditions of the collateral and whether there was an obligation to return the cash. Given that the company has disclosed the quantitative information fully, which is often that which is costly and infeasible, it is likely that non-compliance is due to preparation error and audit oversight. However, non-disclosure of sensitive information should act as a red flag to users and thus it is impossible to rule out that this disclosure might be deliberately withheld.

One element of the reported information – defaults and breaches – seemed somewhat surprising in terms of the number (or rather, the lack thereof) of disclosing entities. Given the uncertain economic climate in late 2007 and early 2008 it was expected that there might be a number of breaches or defaults (IFRS 7.18-19). However, instead it was found that only two companies (Cadbury Schweppes and International Power) claimed to have experienced any difficulties. It has been shown that there is a relationship between default probabilities and the business cycle (e.g.

108 Cash flow hedging gains: £0 (prior year: £0); Cash flow hedging losses: £0 (prior year: £0); Fair value hedging gains: £n/a (prior year: £n/a); fair value hedging losses: £n/a (prior year: £n/a); derivatives gains: £25mill (prior year: £163.5m).
Nickell et al., 2000; Bonfim, 2009). In opposition to this assumption is the argument that the sample of large listed entities are less likely to default than SMEs. Prior work has found evidence that this is especially relevant for those SMEs in developing markets and those with greater pressures on liquidity and profitability (Fidrmuc and Hainz, 2010). In addition, Standard and Poor’s ‘Default, transition and Recovery’ report (2008) opened with the sentence: “Despite the liquidity disruption in the credit markets, the incidence of corporate defaults in 2007 remained low.”109 This prompted a consideration of the disclosure for those two firms who did report breaches or defaults in more detail.

If non-disclosure and rhetoric-based impression management strategies are important to firms, then it is interesting to note that the words ‘breach’ and ‘default’ – with their negative / bad news connotations – are amongst the least used words in the annual report, with both averaging 2.52 uses across the annual reports in the sample (e.g. Skinner, 1994; Merkl-Davies and Brennan, 2007). In addition, almost all of these references are positive signal uses, for example governance policies preventing breaches in contracts or agreements with the Board. One of the finance director’s interviewed (interviewee 16) stated: “when it comes to phraseology you have to be a little bit careful... I think we just want to look as boring as possible”.

The two companies who do provide evidence of breaches and defaults firmly assert that there is no more bad news incumbent or expected with regard to the breaches. Cadbury’s stated there had been a breach in their in-house maturity and institution exposure policies rather than a breach regarding any external financing agreement. The disclosure of internal capital ratio breaches was a feature in the exposure draft but this was removed before the final standard was released. Thus this information is being voluntarily produced and in lieu of a better explanation then one could argue that this is either possibly: a reputation driven disclosure; or, in line with Dye’s (1990) theory, it might be evidence of information being provided as a result of pressure from externalities. The interviews with analysts showed that they felt they

109 It is worth noting that the definition used by Standard and Poor of defaults only captures debt services default (i.e. failing to make a payment of interest or principal) and does not capture instances of technical default (i.e. breaches in covenants).
were able to influence disclosure behaviour\textsuperscript{110} and the preparers said that they could be influenced by the demands of externals\textsuperscript{111}. One analyst (interviewee 1) said: “it is much easier from the point of view that information which they’re likely to be asked which they’re willing to answer... it’s actually easier to put it in than not”. This was echoed by a preparer (interviewee 10) who stated: you can see “the minimum your competitors’ are getting away with or whatever they’re finding useful, or pressure from analysts to provide that, because, you know, well so and so’s doing it and we think it’s really helpful therefore we think you should be doing it, hint, hint... so you do it.”

The second company, International Power, who disclosed a breach during the year stated in their annual report: “Although not in default of principal or interest payment terms, at 31 December 2007 the Group had borrowings of £62 million in technical default which could have allowed the lender to demand accelerated repayment of the loan... The technical defaults were cured during the first quarter of 2008.” This information is not verifiable as an external observer, but the portrayal appears to be skewed towards the current position and there is an emphasis on this being a technical default (i.e. a breach in covenant rather than a missed payment). One might also note the use of the word cured, used most commonly in association with curing illnesses. It should be noted that this disclosure meets the standard’s requirements and therefore should, in the first instance, be seen simply as compliance. Prior work indicates that this would have been discussed at private meetings and therefore key externals would already be aware of the situation (Holland, 1998; 2005). However, the phraseology of the disclosure and the placing of the emphasis might be aimed at managing stakeholders’ perceptions and creating the impression of a solvent entity that has cured a technical problem. It is also possible that the disclosure is part of a legitimacy strategy whereby the entity is offering an explanation of an identified problem and setting this within the social context that users understand (Koonce \textit{et al.} 2005; 2008).

\textsuperscript{110} Although they seemed to believe that their influence extended primarily to discussions through conference calls, investor presentations and private meetings. This echoes Holland’s (1998; 2005) conclusions discussed in chapter 2.

\textsuperscript{111} Although echoing the sentiments of the analysts, they felt that the annual reporting process was less flexible than other outlets in terms of information dissemination.
4.4.3 Income statement and equity disclosures

Given the exclusively hard rules-based requirements in relation to the Income Statement and equity disclosures (ten requirements, all of which are hard rules-based), it is unsurprising that almost all were accurately met (Table 10). The only area where there was multiple non-compliance related to the separate disclosure of available-for-sale financial assets gains and losses. However, based on size, it is possible that this was because these were deemed immaterial. In addition, none of the interviewees thought that there needed to be more information related to these assets and their related performance and therefore the information could be deemed immaterial in nature.

Table 10: Income statement and equity financial instruments disclosures
(IFRS 7: 7.20)

<table>
<thead>
<tr>
<th>Nq</th>
<th>nf</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>66</td>
<td>96%</td>
</tr>
</tbody>
</table>

Note: nq = maximum number of compliance questions applicable to that section; nf = Number of firms with required disclosure

4.4.4 Other aspects of accounting for financial instruments disclosures

Table 11: Other aspects of financial instruments disclosure
(IFRS 7.21–7.30)

<table>
<thead>
<tr>
<th>nq</th>
<th>nf</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>66</td>
<td>87%</td>
</tr>
<tr>
<td>12</td>
<td>62</td>
<td>96%</td>
</tr>
<tr>
<td>16</td>
<td>66</td>
<td>94%</td>
</tr>
</tbody>
</table>

Note: nq = maximum number of compliance questions applicable to that section; nf = Number of firms with required disclosure

4.4.4.1 Accounting policies

As with prior work (Lopes and Rodrigues, 2007), it was found that accounting policies disclosure compliance levels were of a generally poor standard. One finding which is not explored by prior studies is the observation that, unlike the principally
rules-driven requirements referred to in sections 4.4.2 and 4.4.3 above, this is an area where judgement is required. Of the ten accounting policies disclosure requirements, only one is a hard rules-based requirement, three are soft rules-based and the remaining six are principles-based requirements.\footnote{These are not type A requirements according to Alexander’s (1999) classification system as they do not expressly refer to the fundamental principles. However, those classified as principles meet the type B definition insomuch as they ask the firm to present a ”set of rules, conventions or ways of thinking which are to be consistently applied to situations both familiar and unfamiliar.” (Alexander, 1999: 240)} To put the non-compliance in the context of judgement-based disclosures, of the 33 companies who were required to provide a response to the hard rules-based requirement, only one failed to do so adequately. The level of compliance with the judgement driven disclosures was therefore significantly lower producing an overall mean compliance with accounting policy disclosures of 87%.

Though each question contained multiple ‘0’ responses, there were some particularly poor areas of compliance. Of the sample, 10 of the companies that had assets categorised financial assets as available-for-sale\footnote{Many of whom had significant exposures to these assets. Anglo-American, for example, held $3.5bn of available for sale assets at the year-end (at both carrying value and fair value; the equivalent of approximately 14.4% of net assets) whilst at the other end of the scale entities were less exposed, for example Cadbury’s held £2m of available for sale assets at the year-end (which equates to less than 0.05% of net assets).}, failed to adequately state the criteria for designating financial assets as available for sale (IFRS 7.B5(b)). There are no immediately obvious reasons for this disclosure to be withheld and in most cases it is possible that this was the result of preparation error followed by auditing oversight. However, before drawing this conclusion one analyst drew attention to the economic context and in particular the effect the 13 October 2008 reclassification amendments to IFRS 7 might have had on disclosure behaviour. Judging by both the interviewee’s comments and hindsight it seems that the classification of assets and liabilities, and by default their recognition and measurement (at fair value or amortised cost), was a potentially sensitive subject towards the end of 2007 and into the beginning of 2008. It might have been a deliberate choice to disclose only the bare minimum to facilitate later reclassifications without being held back by detailed comparative information from the prior year. There is an argument that this is consistent with impression management. However, this is a tentative suggestion and the most likely explanation continues to be preparation error. Supporting this latter
point, one disclosure preparer (interviewee 12) showed concern about over-disclosure of potentially immaterial accounting policies. He remarked: “We’re having discussions at the moment about IFRS 7 about how much disclosure we need to give. We do do small deals every now and again that are really tiny in a materiality context and yet you look at the standard and it will want us to write like half a page on it. So we have a base where our auditors say, look, this is just not material. Yes, maybe it doesn’t get hedge accounting for this but it has a fair value of less than 10k…so, you’re going to write a paragraph on that? No. Because that would be misleading. Because the reader would misinterpret that to the scale of the risk that it poses.”

Seven companies\textsuperscript{114} failed to adequately disclose the criteria for determining when the carrying amount of impaired financial assets is reduced directly and when the allowance account is used as part of their significant accounting policies (IFRS 7.21d)\textsuperscript{115, 116}. In addition, 10 companies did not state the criteria used for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets. Whilst one might judge this to be common sense, to disclose this information would in most circumstances be both costless and feasible. Therefore

\textsuperscript{114} AMEC; Johnson Matthey; Liberty International REIT; Royal Dutch Shell; Tate & Lyle; Tullow Oil; and Tesco.

\textsuperscript{115} An impairment of an asset is treated for accounting purposes as a charge against income which is offset immediately against profit/loss during the period in which the impairment arises. An allowance account against impaired assets is a balance that can be set up and acts in the same way as a provision. An allowance account is required when there is doubt over the certainty of the inflow of economic resource from the asset. A credit balance is held on the balance sheet and released when there is adequate evidence that the impairment has materialised or that it will not materialise. There will be a change in the value of the allowance account each period and this is taken to the income statement when it arises. For tax purposes only specific allowances are allowed but for accounting purposes many companies still set up both specific allowances and general allowances.

\textsuperscript{116} Where it was possible to locate the balance on the allowance account, the balance sheet value tended to be reasonably small. For example, Liberty reported their allowance against trade receivables was £27.3m (equivalent to 0.6% of net assets). In other cases, it was more difficult to understand whether an allowance account had been used. In the case of AMEC, for example, the current assets receivables note shows one balance of ‘gross amounts due from customers’; but the line that throws the recoverability of all trade receivables in doubt is the explanatory note outlining what the company “expects to recover”. Regardless, if the company has a position where there is a chance that it will not recover then an accounting policy is required to allow users to understand under what conditions the irrecoverability will be recorded. There is a third instance where non-compliance was marked which is more subjective. Namely, where an entity excludes an accounting policy from the accounting policies note, but there is an explanation within the notes to the financial statements. Johnson Matthey, for example, provide a paragraph which outlines when and how allowances against receivables – both specific and general – have occurred plus a quantitative reconciliation of those amounts. They could argue that this is not a “significant accounting policy” per IAS 1.108 or they could argue that the balance is immaterial (£5.7m [of which £5.2m is specific; equivalent to 0.5% of net assets]).
one possible explanation is preparer error and audit oversight. However, this is potentially sensitive disclosure and if one company adopts a different treatment to another, then this may also be costly in terms of the release of competitive information.

Eighteen companies did not mention the criteria used to determine whether there was objective evidence that an impairment loss had occurred (IFRS 7.21f). It is possible that this was deemed irrelevant by preparers (one presumes on the grounds of common sense) and thus excluded. However, alternatively it might have been withheld due to it being potentially competitively sensitive or because disclosure of these details might be deemed negative to users. In 14 of these cases a separate disclosure for impairment was made or there was a reference to the irrecoverability of balances (thus strongly suggesting that an impairment charge has been made – although probably an immaterial one).

There were two opposing voices on issue of withheld (held back) disclosure. A disclosure preparer (interviewee 11), for example, remarked: “At the end of the day you only disclose as much as you have to, because 1) that's what everyone else is doing, and you don’t want to give out more information than you need to because it can become uncompetitive with regards... within your own industry anyway. I know that the industry that we’re in the hedging is extremely important because it affects pricing, but if there’s too much it becomes uncompetitive because then they’ll know what we’re doing and how we control our pricing. That's important to us.” On the other side of the argument, one analyst reported: “even if it’s [i.e. the information] perceived to be useful, whether it is actually useful is another matter... the observation I’d make is that they are in a position where if they don't disclose it then they give rise to suspicion, so as soon as one company is putting in that kind of information out, there’s a kind of implicit, well it’s relevant”.

Following the arguments put forward by researchers such as Koonce et al. (2005; 2008) and Tetlock (2007; 2010) about the potential for positive signal effects in certain phraseology, it is also possible that due to the negative nature of impairment and impairment disclosures, the information carries a negative signal and thus might be withheld or, as has been found, held back thus reducing perceived
Dye (1990) suggested that in the absence of an externality influencing disclosure, the optimal full disclosure policy would not be followed and companies would partially disclose – which is consistent with these findings.

4.4.4.2 Hedge accounting

The disclosures of hedge accounting were clear, coherent, prominent and complete in almost every instance. These high levels of disclosure are consistent with legitimacy theory and impression management. Whilst undertaking the review it appeared that the disclosures of hedge accounting entities (i.e. those firms who met and elected to comply with the IAS 39 rules) were high in terms of both volume and quality. Only the quality aspect appeared to be significant according to findings from the regression analysis carried out as part of this project. Koonce et al. (2005; 2008) found that perceptions of risk can be manipulated by certain phraseology, particularly references to ‘hedging’. Obviously a firm can hedge and choose not to apply hedge accounting rules (or not meet the criteria required in order to apply IAS 39’s hedge accounting rules). The discussion here simply considers the possibility that a firm who meets the hedge accounting criteria will endeavour to present these disclosures given the potential for positive signalling and the impact on reputational capital.

There were a couple of minor discrepancies related to the recognition of the ineffectiveness apparent in profit or loss that arises from cash flow hedges (IFRS 7.24b). It is important to note that during the discussion phase leading up to the release of IAS 39 (SFAS 119 and SFAS 133) it was commonly believed that monitoring ineffectiveness would be disproportionately expensive because of the

---

117 Reducing significance because it is not included within ‘significant accounting policies’.
118 The regression analysis shows a significant relationship (to the 5% level) between the quality of financial instruments disclosure and the value of derivative assets held at the year end. Other unreported relationships in chapter 6 include measures of quality and quantity in relation to not just derivatives assets and liabilities but also cash flow hedging gains/losses; fair value hedging gains/losses and other derivatives gains/losses. In terms of quality, the results indicated a relationship not only with the value of derivative assets but also fair value hedging gains/losses (coefficient: (0.0281); t-stat (-2.09311) and other derivatives reported gains/losses during the year (coefficient (0.01445); t-stat (1.6815). In terms of quantity, no value based independent variable was significant on a univariate simple OLS regression basis (derivative assets: coefficient (-0.0009); t-stat (-1.02122); derivative liabilities: coefficient (0.0003); t-stat 0.2737); cash flow hedging gains/losses: coefficient (-0.0007); t-stat (-0.24517); fair value hedge gains/losses: coefficient (-0.0014); t-stat (-0.0014); other derivatives gains/losses: coefficient (0.0013); t-stat (0.481426)).
inherent complexity of the monitoring process (Osterland, 2001; Louis, 1997). There is the chance that the effectiveness losses (gains) were netted off another balance (e.g. finance costs). If this were the case then this would be an indication of impression management, as this is an indicator of the treasury function performance or/and the inability of management to forward forecast commodity, currency or related hedged item requirements.

In addition, five companies did not disclose the periods when the cash flows related to their cash flow hedges were expected to occur, and when they were expected to affect profit or loss (IFRS 7.23a). These non-compliant companies were reviewed further and it was found that the most likely explanation was that the positions were expected to impact on cash flows and profits within the following 12 months, and therefore any extra disclosure would have been deemed redundant.

It seemed appropriate, whilst reviewing the hedging disclosures, to identify whether companies specifically stated their attitudes towards using derivatives as speculative instruments. Though this is not a requirement of IFRS 7,119 many companies still voluntarily disclosed this information. Many prior studies investigating derivatives-based hedging strategies have issued warnings that speculation could not be detected and therefore their results risk being incomplete. Though it might be prohibitive in terms of time required when investigating a large sample of entities, it is possible to directly consult the financial statements and find an appropriate answer to this question. In this regard, it was found that 16 companies excluded the statement that they are not holding derivatives for speculative purposes. To put these findings in context see appendix F which analyses the derivatives positions and performances of these entities. Of the 16 companies who omitted a phrase about being non-speculative, every firm had some exposure to derivatives assets or (and in many cases - ‘and’) derivative liabilities. In addition, 10 of these entities had gains and losses arising as a result of changes in the fair value of derivatives during the year120.

---

119 Unless one considers this to be part of the risk management policies requirements – IFRS 7.33b
120 The average recognised fair value gains for these entities was £209m during the year but the standard deviation reflects the fact that 3 entities have significantly larger exposures to these financial instruments and associated gains and losses. When the results of these 3 entities are withdrawn the average is just £6m.
It could be argued that this is mitigated to some extent because this means that the majority of companies, 50 (76%) of the sample, have expressly made the statement they are not speculating with their financial instruments. One can also assume that this statement when disclosed is materially accurate, as each of these companies’ auditors have agreed that this statement is materially correct. However, for those seeking evidence that companies are using derivatives for speculative purposes, then they might consider this to be a useful starting point.\(^{121}\) It was found that, of these 16 companies, several hold derivatives for trading and either generate separately classified revenues from those operations (Centrica; International Power) or disclose that these derivatives are part of a speculation strategy (e.g. BP).

4.4.4.3 Fair value

A high level of compliance was also noted with regards to the fair value disclosures (IFRS 7.25–30). This was found to be true even despite the lead towards judgement driven requirements in relation to fair value disclosures (6 hard rules-based; 7 soft rules-based; 3 principles-based). These disclosures were clear and complete and this might have been predicted given the arguments about positive signal information (Koonce et al., 2005, 2008) and the fact that fair value reporting has been assailed by concerns and controversy about the underlying concepts and usefulness of fair value (disclosures) and therefore entities might be acting to provide a fuller picture. In addition, the evidence from interviewees suggests that fair value information – whether or not individuals believed it to be timely, comparable or verifiable – was important and relevant.

There is an argument that if one company discloses and another doesn’t, then the non-disclosure is potentially costly (e.g. Rajgopal, 1999) and therefore this becomes proprietary information (Dye, 1990) – even if the disclosure itself is simply a uniform set of policies. Consistent with a legitimacy theory assumption it was found that companies appeared to have accurately outlined their accounting policies related to

\(^{121}\) Further discussions of this issue continue in Chapter 5.
fair value, and subsequently ensured that they fulfilled compliance with the 16 questions that related to the disclosures of the fair value of financial instruments.

It is interesting to note that one finance director (interviewee 11) stated the following during a discussion about fair value and the information required by IFRS 7: “We would not have produced this analysis unless we’d been asked to. We would not have disclosed some of the fair values... anything with fair value unless we’d specifically been asked to do so, because we want to hide that.122 At the end of the day you only disclose as much as you have to, because... that’s what everyone else is doing, and you don’t want to give out more information than you need to because it can become uncompetitive with regards... within your own industry anyway.”

It was found that the only significant non-compliance issue regarding fair value disclosures related to the disclosure of investments in equity instruments that do not have a quoted market price in an active market, and derivatives linked to equity instruments that are measured at cost because their fair value cannot be measured reliably (IFRS 7.30). Of the 17 companies who were required to prepare these disclosures, 16 (94%) made one or more omissions from the five disclosure questions that were relevant. The information is sensitive, likely to be proprietary and the costs associated with incorrect fair values are potentially great. The issue put forward by comment letter respondents and interviewees who were preparers of information was that the disclosure might fundamentally lack credibility and arriving at an answer might not be feasible. They expressed concerns that incorrect information or inaccurate valuations would be perceived more negatively than partial or non-disclosure. This issue was brought under review123 Interviewee 15, for example, said: “So what we disclose is the right thing and then what we discuss with the auditors is another case.... We do what we think is the smartest and then after that we discuss it with the auditors that... why should we use resources to calculate this stupid thing. And hopefully we can convince them.” The IASB set up an Expert

122 Note: earlier in the discussions the interviewee had made reference to the fact that the IASB had not provided enough clear guidance regarding fair values and expressed concerns particularly about the issues of timing and verifiability. However, he also stated that he did not follow others annual reporting in great detail and therefore this suspicion could not be confirmed. 123 Financial Stability Forum made note of this issue in their report Enhancing Market and Institutional Resilience.
Advisory Panel to investigate this issue. The Panel released a document in September 2008 entitled *Measuring and disclosing the fair value of financial instruments in markets that are no longer active.*

4.4.5 Nature and extent of risks arising from financial instruments disclosures

Consistent with the predictions of positive phraseology signals (Koonce et al., 2005, 2008; Tetlock, 2007) and consistent with legitimacy and impression management it was found that the disclosure of financial risks and the way they are being managed was highly compliant with IFRS 7 requirements. Interviewees consistently thought that these disclosures were important and the more accurate and reliable detail that was provided was a benefit to accurate valuation and predictions of future cash flows. Equally, analysts argued that inaccurate or vague information would be punished appropriately. In addition, these disclosures might provide a company with an opportunity to convince users that their risk management strategies, processes, policies and objectives are robust and appropriate. The economic effects of the disclosures of financial risk management policies are potentially significant, given the association with reductions in the cost of capital.

This point was raised by several interviewees. One treasury director (interviewee 7), who played a significant part in the preparation of the disclosures, said the following: “I think the quality, I mean, I think the qualitative disclosures that we’re making make a lot of sense. We do go into a lot of detail about different forms of risk that we encounter, how we manage those risks and that sort of thing, but when it gets to some of the quantitative disclosures it begins to make less sense.” Later in the interview he returned to this subject whilst discussing the issue of over-burdening the reader with information. He argued: “I’m very clear in saying you don’t want to bog the reader down in an enormous amount of detail and it does actually focus on significant risk, and that’s what we’ve done effectively. I mean from our perspective the most significant risk really is liquidity risk and we do explain to the reader what the risk is, how we managed it and the fact that, based on everything we’ve looked at

---

124 On 29 June 2010 the IASB published an Exposure Draft *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* and on 19 August 2010 the IASB released a staff draft of a forthcoming IFRS on fair value measurement.
internally in how we manage risk, and we’re going to manage it for the next whatever, 12 months, 18 months. So we definitely focus on the more significant risk. The only disclosure I think we... the qualitative disclosure we aren’t just throwing things in there for no reason, we’re very careful with the qualitative disclosure, we do try to provide meaningful disclosures and I think if you can read it and understand it I think it will give you some insight into some of the risks that [the business] is exposed to”. As stated previously, this remark echoed those of other preparers particularly.

Table 12: Nature and extent of risks arising from financial instruments (IFRS 7.31–42)

<table>
<thead>
<tr>
<th>Risk Type</th>
<th>Qualitative disclosures</th>
<th>Quantitative disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit risk</td>
<td>6</td>
<td>1</td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Market risk</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Other risk</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Credit risk</td>
<td>9</td>
<td>66</td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>8</td>
<td>66</td>
</tr>
<tr>
<td>Sensitivity analysis</td>
<td>7</td>
<td>66</td>
</tr>
</tbody>
</table>

Note: nq = maximum number of compliance questions applicable to that section; nf = Number of firms with required disclosure

4.4.6 Credit, liquidity, market and other risks

As shown by the interview evidence quoted above, the majority of the financial risk information was presented by companies in a way that was sensitive to its potential impact. It is difficult to draw any general conclusions because each company’s disclosure approach, terminology and risks are different, but they all appear to share a polished clarity. Interviewees generally agreed with the presumption that these disclosures were an opportunity to maximise reputational capital. However, it is worth noting that certain interviewees referred to the possibility that there could be information obfuscation due to excessive detail and their own time constraints. When further questioned on this issue, they stated that this information overload problem could be deliberate. One analyst (interviewee 1) for example stated: “I am sure that
fairly frequently there is stuff that is put in that is obfuscatory but it's hard for me to differentiate that”.

In total there were 49 disclosures related to the nature and extent of risks arising from financial instruments the majority of which were judgement driven. There appear to be 19 principles-based, 20 soft rules-based and 10 hard rules-based requirements. Many of the disclosure requirements are open ended and therefore the quantity of information varies depending upon the level of exposure to these risks and the policies and processes adopted. With regards to the credit, liquidity and market risk numerical and narrative disclosures, the majority of non-responses most likely arise from the fact that the company, based on their individual risk profile, has deemed the disclosure irrelevant and immaterial.

Rather than particular requirements not being met it was found that individual companies were non-compliant with sections of the disclosure. One company disclosed only the quantitative exposure to credit risk in the notes to the financial statements and summarised their policies, processes and management of credit risk in the Business Review section, with the sentence: we mitigate counterparty credit risk by “spread[ing] sources and maturities of facilities”. This is overly brief and arguably lacks usefulness. Another company disclosed the bare minimum information required by IFRS 7 but without providing what the coder judged to be useful information to users. Another entity simply narrated the fact that they hold significant cash surpluses and this is the method by which their risk exposure is managed. Though this might be true, given the economic downturn and savers being afforded low interest rates, then a stakeholder would prefer assurances regarding

---

125 Liquidity risk has become the subject of concentrated focus and the IASB released an Exposure Draft, *Improving Disclosures about Financial Instruments*, in December 2008, requiring companies to make fuller disclosure related to their liquidity risk.

126 The extract from AMEC’s annual report related to credit risk reads as follows: “The Group’s exposure to credit risk is regularly monitored and the Group’s policy updated as appropriate. Debt, investments, foreign exchange and derivative transactions are all spread amongst a number of banks all of which have short- or long-term credit ratings appropriate to the Group’s policies and exposures. The investments made by the insurance companies, which hold the bulk of the Group’s cash investments, are reviewed regularly by the appropriate boards and judged against existing investment policies and counterparty credit risk policies. Trade receivables primarily comprise balances due from individual fixed line and mobile customers and balances due from network operators. Network operators are generally major multi-national enterprises with whom the Group has well established relationships and are consequently not considered to add significantly to the Group’s credit risk exposure. Provision is made for any receivables that are considered to be irrecoverable.”
both their interest rate risk management (downside and upside) and their level of protection over those cash balances.

The market risk disclosures were met fully, but given the level of detail in relation to credit and liquidity risks, it was somewhat disappointing that many companies simply met the minimum requirements, adding little detail over and above some standardised terminology. This might be due to the uncertain economic climate guiding disclosure strategy. It has been shown that companies who get sued disclose less after litigation (Graham et al., 2005; Rogers and Van Buskirk, 2009) and this might be an example where sophisticated entities like those studied are pre-empting potential litigation. However there are other possible explanations. Interviewees often argued that the annual report was becoming less useful and the relevant information was sometimes released through other disclosure mechanisms.

4.4.7 Sensitivity analysis

Given the high levels of disclosure in the other sections, it was surprising to note the levels of non-compliance in the disclosure of sensitivity analysis – which stands out as being particularly poor. This information is meant to provide forward-looking, useful information to investors about a company’s open positions, and was a significant addition to IAS 32 disclosures. It was noted that three companies provided no sensitivity analysis at all, whilst 26 companies did not provide the requisite detail regarding the underlying methods and assumptions used to calculate the sensitivity.

However, there is evidence from comment letter responses and from interviews that one could have predicted this outcome. Respondents produced a series of arguments against this disclosure including: it would not be feasible to produce for smaller entities, some industries and those with complex arrangements and portfolios; it was overly simplistic and it was already produced for and by analysts in a more coherent and sophisticated manner; it was not costless to produce; and it might lack credibility because of a lack of comparability, verifiability, timeliness and a lack of guidance related to sensitivity rates to use and because the balance sheet position might be misleading, given that it captures one moment in time.
The sensitivity analysis became a central theme during interview 2\textsuperscript{127} during which the disclosures were criticised. The interviewee stated: \textit{“And then there are these funny little sensitivity type things which, dare I say, I find them pretty useless... there are so many assumptions you have to make”}. Later in the interview a further contribution on this subject was made. The interviewee added: \textit{“the sensitivities... that sort of thing that’s come in with IFRS 7, I have to say that I don’t find that very useful at all, because there’s going to be so many assumptions, underlying assumptions in getting to one number, and the assumptions that have to be disclosed... well, I’m not sure how helpful that disclosure is.”} This was reinforced again later when it was argued: \textit{“I mean you can understand why it’s there I suppose... but it is a very crude way to do it!”} Another analyst and ex-audit senior manager at a Big Four firm expressed similar sentiments about these sensitivity disclosures adding: \textit{“that sort of disclosure is only there because they have to do it, it’s not useful for people, and in fact, the information is produced in a different way for the benefit of valuation models, in a way that is much more useful”} (interviewee 3). Another analyst (interviewee 8) commented: \textit{“what is the difference between an untruth and a lie.... it [the disclosure] doesn’t lie, it misleads.”} It was not just analysts who criticised these quantitative disclosures. One treasury director (interviewee 7) said that the problem is: \textit{“you end up with some kind of probably... I wouldn’t say, well, useless, yes, maybe useless disclosures...”;} and later: \textit{“[they’re] definitely misleading the reader, unless they really understand what it is.”} Whilst another (interviewee 9) claimed that it was the kind of information \textit{“someone can do on the back of a fag packet themselves”}; and later she argued, \textit{“it’s not rocket science”}. Another finance director (interviewee 15) argued simply: \textit{“Well I think that [sensitivity analysis] is very stupid.”}

Despite this, some companies produced thorough sensitivity analyses not only because this is full disclosure but also because arguably this is the optimum disclosure. The disclosure of this information could provide an opportunity (consistent with observations above about hedge accounting and fair value disclosures) for management to legitimise financial risk management strategies. This information would almost certainly be released to analysts in a more user friendly

\textsuperscript{127} Interview 2 was conducted with two people – the head of investor relations (ex-analyst) and a senior member of the entity’s investor relations team (and ex-accountant).
format, a more timely fashion and through other communication means. As interviewee 17 stated: “it’s about keeping lines of communication open. That’s how I get my info. That’s how I stay ahead”. In addition, it should be noted that not all interviewees were negative about this disclosure and many thought that this was a good “halway house” (interviewee 4); a “move in the right direction” (interviewee 7); “well intentioned” (interviewee 9); and that “the underlying sentiment [behind the sensitivity analysis] is commendable” (interviewee 18). Ultimately one of the reasons why this disclosure might have met with poor compliance was because of the difficulty (and thus cost) to produce the information. However the material accuracy of the data was defended, for example, interviewee 13 said: “I think the reason that I say that I don’t like that [i.e. the sensitivity analysis] is it actually was very hard work for us to get that number and we ended up making an awful lot of guesses, and therefore... I mean obviously they’re very intelligent guesses and I’m sure the number is right within a degree of...”

4.4.8 Early adoption disclosures

As table 13 shows, only three companies chose to early adopt IFRS 7, and they all disclosed this fact.

Table 13: Early adoption disclosures
(IFRS 7: 7.43–7.44)

<table>
<thead>
<tr>
<th>Adoption of standard before effective date</th>
<th>nq</th>
<th>nf</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>3</td>
<td>100%</td>
</tr>
</tbody>
</table>

Exemption in the first period of adoption before 1 January 2006 from presenting certain comparative information

<table>
<thead>
<tr>
<th>Exemption in the first period of adoption before 1 January 2006 from presenting certain comparative information</th>
<th>nq</th>
<th>nf</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>0</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Note: nq = maximum number of compliance questions applicable to that section; nf = Number of firms with required disclosure

4.4.9 Retracted disclosure

It has never been the intention of this work to identify what should and should not appear as disclosure but rather to provide a commentary on the compliance with the mandatory disclosure requirements of IFRS 7. However, during the review and interview process limited evidence was found to provide a level of substantiation to Dye’s (1985) claim that some disclosure (which might be deemed important to
stakeholders) can be lost when a voluntary disclosure regime converts to a mandatory one.

Two of the analysts interviewed talked about disclosures being retracted when there was a change of disclosure environment. Only one of these interviewees could provide further evidence of this phenomenon when asked for further details. He claimed that he had raised at private meetings, investor presentations and conference call events the issue of omitted or deleted disclosures and asked relevant parties to either justify the exclusion or to present it. One example occurs in the annual reporting of International Power. This company disclosed on page 120 and 121 a table illustrating the effective interest rates of interest earning financial assets and interest bearing financial liabilities broken down by currency alongside a maturity profile. The closest information that exists in the 2007 annual report appears on page 158 where this disclosure was reduced to an “analysis of the contractual undiscounted cash flows relating to financial liabilities at the balance sheet date and reconciliation from undiscounted cash flows to carrying amounts.” The currency and type of these financial liabilities is not published. Interviewee 8 stated: “and you can see we’ve lost a lot of that previously disclosed information, there’s no currency, no interest, nothing... I mean it’s just a massive loss of quality information because of IFRS 7”.

This information was important to this analyst and he argued that others just hadn’t noticed this missing information because they didn’t go into the necessary detail. He suggested he would “mark them down if they don’t come out with it next time”. However, the problem from an analyst’s perspective is the underlying question: why is this information being retracted? When interviewed, preparers did not say that this was something they were aware of and argued that if it was then it was not deliberate. In addition, investor relations personnel interviewed reported that that they received no enquiries of this type.

4.5 Conclusions, recommendations and limitations

This chapter provides the first thorough review of the mandatory disclosure reporting requirements prescribed by IFRS 7. This is a sensitive reporting area and significant
deviations in quality and quantity from one company to the next were noted. Nevertheless, largely speaking, the disclosure standard has been adopted wholesale, and with minor exceptions, the level of compliance was high. This stands in stark comparison to all prior studies of financial instruments compliance (Elmy et al., 1998; Roulstone, 1999; Chalmers and Godfrey, 2000; Chalmers, 2001; Chalmers and Godfrey, 2004; Bhamornsiri and Schroeder, 2004; Jones and Wei, 2004; Woods and Marginson, 2004; Lopes and Rodrigues, 2007; Hassan et al., 2008) but remains consistent with the legitimacy (reputation enhancement) and impression management theories of prior studies (Chalmers and Godfrey, 2004). In this light, high levels of compliance might be expected, for example in the area of hedging. It is these disclosures that are more likely to be associated with wealth creation, risk minimisation and reputation preservation (Koonce et al., 2005; 2008) which were found to be met with higher levels of quality (and quantity).

Also contrary to prior studies (e.g. Bhamornsiri and Schroeder, 2004), it was found that the disclosure followed easily recognisable reporting patterns. Neither the coder nor interviewees found that incoherence and lack of uniformity were issues. However, interviewees did argue that these disclosures are intended for those who are sophisticated users of financial information and those with a significant amount of time to review them. Unfortunately, interviews revealed concerns in both regards and thus put forward the opinion that a two-tier reporting system was emerging whereby the annual report was in the process of being downgraded. One analyst, for example, argued that it is “language that is penetrable [but] only to seasoned professionals who have to deal with the language all the time, so it will be analysts, arguably perhaps employees, accountants, maybe even lawyers who are pretty smart both analytically and – sorry, both mathematically and in terms of their literary abilities and then academics. But I don't think it’s penetrable to the average manager and certainly not to others... and in that respect they’ve [the IASB] have failed”.

(interviewee 4)

Though disclosure levels were high, evidence was consistently found evidence of non-compliance. This is worrying insomuch as the entities considered by this study were the largest non-financial firms listed in the UK, and they were all audited by the elite auditors. Therefore, there is the possible concern that as companies and their
auditors\textsuperscript{128} become less expert, smaller, less resourced and less practised then their levels of disclosure will reduce.

A conceptual framework was designed to enable an examination of non-compliance further, starting with Dye’s proprietary information theory and leading to sociological and behavioural explanations. Evidence was found that suggests that non-compliance was mainly driven by cost, but also by preparation error, impression management and legitimacy. The high levels of compliance mean that audit error was low; however, where this error exists it is not possible to calculate the economic impact because, contrary to Lundholm and Van Winkle’s (2006) conclusions, this information has never, and most probably will never, become available.

One area of systemic weakness related to the poor preparation and presentation of the sensitivity analysis. Comment letters in relation to ED 7 and interview data highlighted that levels of non-compliance were likely. One might argue that if this disclosure is not produced by entities and there is no ex-post litigation then it should either be revisited and improved or simply removed. However, this does not provide auditors with an excuse to not ensure full compliance.

This study should act as an aid to help users of financial information understand the adoption and application issues related to IFRS 7. It is hoped that this study should also assist standard setters regarding where their future energies should be directed if they are concerned with overall compliance. Preparers might also review whether any previously made voluntary disclosures would add value to the mandatory disclosure requirements.

\textsuperscript{128} With the exception of those firms with a particular specialism in auditing firms with heavy financial instruments, (particularly) derivatives usage.
Introduction to Chapter 5

The compliance review presented in the last chapter highlighted issues of full, partial and non-compliance. However, the compliance review also allowed an identification of several instances of over-compliance with the IFRS 7 requirements. In effect, these are voluntary disclosures as they are provided over and above those which are mandatorily required. The primary contribution of this study is the evidence of the existence of voluntary disclosures in a mandatory environment which challenges some prior theoretical arguments.

This chapter presents findings from a close examination of selected additional disclosures on a case-by-case basis which have been deemed material either by nature or in size. As with the previous chapter – regarding full, partial or non-compliance – any conclusions must be presented based upon an assessment of most likely outcomes given the asymmetric nature of the disclosure decision. However, where possible, the level of subjectivity is minimised as far as possible by substantiating the conclusions by relevant qualitative and quantitative data and also by presenting the other possible conflicting rationale.

In many cases the voluntary disclosures appear to be presented in a manner that correlates with a legitimisation strategy. Interestingly, and contrary to discussions in recent studies, the disclosures seem to support both organisational legitimacy and institutional legitimacy theory. On occasion, in addition, there is some evidence that supports the possibility of impression management within the disclosures.
Chapter 5: An examination of voluntary financial instruments disclosures in excess of mandatory requirements by UK FTSE 100 non-financial firms

Purpose: Our study addresses “the existing literature gap on the information content of derivatives reporting” (Wang et al., 2005: 425). Prior work finds failings in compliance with mandatory reporting requirements in respect of financial instruments and derivative financial instruments. Instead of identifying weaknesses in compliance our study identifies where firms over-comply or in other words, where firms voluntarily disclose more than they are required and whether this is incremental information or serves another purpose.

Design/method/approach: We review the financial instruments disclosures of the FTSE 100 non-financial IFRS 7 compliant firms. Based on these results, on a case-by-case basis we address potential causes and rationale for this extra disclosure.

Findings: Prior research suggests that it is counter intuitive to argue that firms will provide voluntary disclosure in a mandatory reporting environment because information of this sort tends to be proprietary and competition sensitive, not to mention costly to prepare. However, we find that firms have voluntarily published information in excess of the requirements and we suggest that this extra detail is most commonly associated with a legitimation strategy.

Originality/value: In spite of the importance of derivatives usage and management in addition to the increased and often complex reporting requirements, we are not aware of any previous study of this type.

Keywords: Financial instruments; voluntary disclosure; mandatory disclosure

---

Note: this paper has been published in the Journal of Applied Accounting Research, Vol. 11, No. 2, pp. 133–153. The paper appears here in full and without amendment except for the removal of the references section. Prof. McMeeking is a named co-author as he has also been my supervisor through my PhD studies. I am thankful to him for his guidance through the publication process but from a logistical perspective, his role in the project was largely supervisory. The data collected and the analysis performed was almost entirely the author of this thesis’ work.
5.1 Introduction

Few disclosure researchers have chosen to investigate financial reporting driven mandatory disclosure. Instead there is a vast and growing body of work investigating voluntary disclosures. In particular these studies focus on specific unaudited areas of the annual report such as the financial review, chairman’s statement and the social, ethical and environmental report. The studies of mandatory disclosure that do exist tend to focus on either audit (failure)/compliance or information value relevance. Our study instead asks two inter-related questions and answers these issues in a unique way:130 ‘do firms voluntarily disclose information in excess of the mandatory requirements; and if so, why, when this information is costly to prepare (time spent and data availability), proprietary in nature, and competition sensitive?’

The sample chosen for this study was the non-financial FTSE 100 firms reporting under International Financial Reporting Standard 7 Financial Instruments: disclosures (IFRS 7). The Standard became effective for reporting purposes for UK listed group entities for annual periods commencing on or after 1 January 2007 (although early adoption was allowed). Financial firms were omitted from the sample because of the complexity of their derivatives usage and hedging arrangements which ultimately affects the intricacy and volume of their disclosure practices. FTSE 100 companies were chosen because they are exposed to greater levels of risk, use financial instruments more frequently and disclose more information than other UK firms.

This study makes certain key contributions to the existing literature. Firstly, we find evidence that firms do voluntarily provide information over and above the requirements of IFRS 7. Secondly, we find empirical evidence that in some parts substantiates prior statistical disclosure modelling papers and in some parts runs contrary to it. We find that there is evidence of voluntary disclosure and that this information holds some incremental value but there is generally a qualifying underlying purpose for this information. Thirdly, we find that within a mandatory

130 Occasionally studies (for example Bryan, 1997), have identified incremental information but the majority of investigations into incremental information content seek to identify whether information other than the annual report provide additional value to that provided elsewhere (for example Hoskin et al., 1986).
reporting environment there is evidence that corroborates legitimacy theory. Finally, we use a novel method to extract and analyse voluntary disclosure that tests whether firms report information above and beyond what is required by IFRS 7.

The remainder of the paper is organised as follows. The next section presents an overview of the previous literature. Section 5.3 outlines the conceptual framework and research methods adopted in the paper. Section 5.4 presents and discusses the key issues and results. Section 5.5 draws some conclusions and sets out the limitations of the study alongside providing some areas and recommendations for further research.

5.2 Literature

There is a vast body of research investigating disclosure practices and purposes which has been summarised by other commentators (see Healy and Palepu, 2001; Verrecchia, 2001; Botosan, 2006). Voluntary disclosure is an area of great and growing interest because it offers many positives over studying mandatory reporting practices. Amongst these advantages are that it is readily accessible, requires limited technical accounting knowledge to interpret and is comparatively straightforward to review using computer-based techniques. However, despite the benefits of studying voluntary disclosure, researchers have cast doubt on its relevance and usefulness and especially its importance to investors and analysts (Campbell and Slack, 2008; Chang and Most, 1985).

Voluntary disclosure has been defined by FASB (2001: 5) as those “disclosures, primarily outside the financial statements, that are not explicitly required by GAAP or an SEC rule”. This definition can, and has been, translated through to the international and UK context. Technically therefore the disclosures examined in this chapter which are provided in excess of IFRS 7 do not meet this definition because they fall within the financial statements. However, they are neither explicitly required by IFRS 7 and are not produced in response to listing rules or legal constraints.

The major differences between the disclosure identified by this project as being voluntary and those that meet the definition of voluntary above include: the position
of the disclosure (in the notes to the financial statements); the fact that it has been
audited; and the connectedness of the disclosure to the mandated disclosure. An
argument could be made that the disclosures studied in this project are triggered by
the underlying mandatory requirement and thus should be considered as part of the
compliance with that requirement. However, in terms of the requirements and their
being met, there must be an end to the mandatory portions as well as a beginning.

Offsetting this point further is the fuzzing boundary between what is mandatory and
what is voluntary reporting. One might query whether the work done by the
international standard setters (e.g. FASB, 2001; SEC, 1989 [MD&A]; IASB, 2010
[Management commentary]; FRC, 2008 [Operating and Financial Review]) has, in
effect, theoretically mandated voluntary disclosures by providing guidance over ‘best
practice’. Therefore, a further argument could be made that the boundary between
voluntary and mandatory disclosure is closing and when one entity makes a
disclosure – whether in the annual report (financial statements or other sections) or
elsewhere – then competitively others will be compelled to follow suit and this will
become mandatory in spirit even if not in law or regulation (e.g. Chamley, 2004; and
Hirshleifer and Teoh, 2003).

The interview evidence corroborated this notion (see chapter 4 for further details)
with one preparer (interviewee 11) stating: “At the end of the day you only disclose
as much as you have to, because... that’s what everyone else is doing”. An investor
relations director (interviewee 20) argued that if others in the same industry were
disclosing information then they would also have to produce it regardless of there
being any rule or regulation enforcing the disclosure. Several voluntary disclosure
studies have found similar patterns in different scenarios (e.g. Daske et al., 2008
[voluntary early adoption of IFRS]; Yu, 2011 [increased voluntary disclosures to
reconcile US GAAP and IFRS]; Chalmers and Godfrey, 2004 [voluntary adoption of
non-mandated requirements]; Cairns. 1996 [banking sector voluntary early adoption
of financial instruments standards]; Muller III et al., 2008 [voluntary early adoption of
IAS 40]; Barako et al., 2006 [comparable industry-wide voluntary disclosures]). The
issue of the fineness of the line between mandatory and voluntary is not limited to
accounting studies; it is also present in areas such as: law (e.g. Kates, 1983); food
safety (e.g. Segerson, 1999); agricultural policies (e.g. Bosch et al., 1995); medicine (e.g. Cohen, 2000); and so forth.

However, the disclosures studied in this chapter were identified precisely because they did stand out as being made in excess of a requirement and were not being made by every company in the sample, or even in the same industry. In addition, they appeared to contribute information (and thus potential value) to the mandated disclosures and therefore were separately investigated because of their possible usefulness. The definitions of voluntary and mandatory (rather than the terms ‘voluntary disclosure’ and ‘mandatory disclosure’) help to reconcile this issue more clearly by highlighting that the disclosure reviewed in this chapter meets many of the definitions of ‘voluntary’ and none of the definitions of ‘mandatory’.

Voluntary means (Merriam-Webster, 2011; Oxford, 2011):

1. proceeding from the will or from one’s own choice or consent;
2. unconstrained by interference: self-determining;
3. done by design or intention;
4. of, relating to, subject to, or regulated by the will;
5. having power of free choice;
6. provided or supported by voluntary action; and
7. acting or done of one’s own free will without valuable consideration or legal obligation.

Mandatory means:

1. containing or constituting a command;
2. an official order or commission to do something; and
3. (be mandated to) historical (of territory) be assigned to (another power)
under a mandate (e.g. of the League of Nations).

In addition, the basic premise put forward by the FASB (2001) report on voluntary disclosures was that (p.3) “companies that make voluntary disclosures have chosen to differentiate themselves by enhancing the amount of business information they provide. Effective voluntary disclosures can provide more transparency and understanding about the company to investors and creditors. Generally speaking,
informative disclosures help investors better understand a company’s strategy (including how it addresses opportunities and risks); critical success factors that are important to the company’s future; the competitive environment within which the company operates and the framework within which decisions are made; and the steps the company is taking to ensure sustainable results.” Many of the disclosures provided in excess of IFRS 7 meet this definition.

It is common for disclosure studies to assume that managers have superior information to outside investors about their firms’ prospects. Managers make accounting decisions and disclosures to communicate their superior knowledge to investors and to manage reported performance for contracting, political or corporate governance reasons (Healy and Palepu, 1993, 1995, 2001).

The extant literature identifies five key factors that influence voluntary disclosure decisions for capital market purposes. Firms engage in voluntary disclosure to: (i) reduce the information asymmetry associated with capital market transactions; (ii) explain away poor performance; (iii) increase the liquidity of the firm’s shares and reduce contracting costs; (iv) mitigate the threat of litigation; and (v) signal the quality of management. One unintended consequence which has a repercussion on the mandatory reporting practices of companies is that there is a willingness to disclose more information when firms have bad news because of the necessity to meet the needs of stakeholders (Skinner, 1994; Li, 2008; Bloomfield, 2008). Specifically, firms voluntarily disclose information to mitigate against the potential for adverse selection that would arise from non-, or a lack of, disclosure (Grossman, 1981; Milgrom, 1981). However, firms are concerned that voluntary disclosures may damage their competitive position in product markets (Barry and Brown, 1985, 1986; Healy and Palepu, 1993, 1995, 2001).

The extant literature contends that the style and content of annual reports can be set within the constructs of legitimacy, reputation risk management and corporate social responsibility on the one hand, and political economy, impression management and marketing interpretations on the other (Bebbington et al., 2008; Polonsky and Jevons, 2006; Chalmers and Godfrey, 2004; Aerts and Cormier, 2009; Branco and
Rodrigues, 2008; Stanton and Stanton, 2002). Our study finds mixed evidence of the former.

The key distinguishing characteristic of these two schools of thought – legitimacy and impression management – is the intention and direction of the management of information. Voluntary disclosure in a legitimacy theory framework is defined as organisations voluntarily disclosing information to justify the company’s activities, conform to social norms and/or manage what stakeholders are expecting to read. This often involves the legitimisation of specific transactions and business decisions. By contrast, voluntary disclosure in an impression management framework is the disclosure of information to create a general impression of the firm and offset any potential bad news. Impression management studies can be criticised for focussing on external audiences and public behaviour however maybe this is justifiable when one considers the underlying purpose of impression management. In our opinion, impression management stems from an initial position whereby the information is intended to deliberately affect or manipulate the impression which the information might have caused given no discussion or disclosure. In contrast, legitimacy theory looks to, as the name suggests, legitimise operations, actions or events.

Legitimacy is defined as (Suchman, 1995, 574) “a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions.” This definition unravels into two separate strands: institutional legitimacy and organisational legitimacy (see discussion in Tilling and Tilt, 2010). Due to a combination of factors including the relative size, nature and level of institutional ownership of firms featured in accounting studies, commentators have deemed institutional legitimacy – “how organisational structures as a whole… have gained acceptance by society at large” (Tilling and Tilt, 2010:57) – as considerably less relevant as an underpinning theoretical explanation for disclosure practices. Organisational legitimacy however has been the focus of attention given that it refers to the concept that organisations attempt to ensure there is an apparent symmetry between the social values, strategies and operations of the company and the “social norms of acceptable behaviour in the larger social system or environment they are part of” (Dowling and Pfeffer, 1975: 122).
Reputation is conceptualised by economists as an intangible asset with the potential for value creation and by sociologists as the outcome of shared socially constructed impressions of a firm (Dierickx and Cool, 1989; Barney, 1991; Fombrun and Van Riel, 1997; Scott and Walsham, 2005). Reputations are one of the key foundations of companies’ actions and firm value is structured upon assessments and management of those actions (Schweizer and Wijnberg, 1999). A hierarchy of reputation is created and reputation risk is the extent to which any one aspect of reputation may be lost by an organisation (Fombrun and Van Riel, 1997; Fombrun et al. 2000; Chalmers and Godfrey, 2004). Within this context firms voluntarily disclose information to manage reputation risk as part of their overall risk management strategy.

Reputation risk management is occasionally cited as the theoretical underpinning to explain disclosure practices and policies (Polonsky and Jevons, 2006). Studies in this area can be criticised for the inherent problems associated with the conceptualisation, characterisation and measurement of reputation risk (Deephouse, 2000). At the heart of this problem is a failure to investigate the “broader context… or the realities of organizational processes and their participants” (Adams, 2008, 367).

Reputation is complex in nature and is often both specific to a particular organisation and dependent on historical events that are difficult to untangle ex-post (Barney, 1986; Dowling, 2001; Dierickx and Cool, 1989). A recent review of the extant corporate reputation literature concluded that reputation, in the context of corporate practices, lacks a comprehensive and accepted definition (Walker, 2010). Another conceptual difficulty associated with this strand of literature is the problem associated with isolating reputation risk management from the management of other organisational processes (Fombrun and Van Riel, 1997; Hutton et al., 2001). Although, there is clear evidence of reputational risk management in voluntary disclosure (Hooghiemstra, 2000) prior studies are scant (Shenkar and Yuchtman-Yaar, 1997; de Castro et al., 2006). Studies that do exist often fail to adequately distinguish between these theories, as exemplified by Adams (2008) in the discussion of Bebbington et al. (2008: 368), “Should we rename legitimacy theory reputation theory? Would that solve the problem?”
Holland (1998; 2005) undertook a study investigating disclosure behaviour which concluded with the argument that there is a wide area between mandatory public disclosure and market failure and part of this void was filled with public voluntary disclosure. His interviewees led to the proposal that these public voluntary disclosures were produced (1998: 29-30) “up to (or towards) the point where it was thought sufficient to satisfy external or market benchmarks for good communication, to satisfy the law and Stock Exchange regulations, financial reporting standards and Operating and Financial Review guidance, to legitimise additional private disclosure around the same public information, and where it also satisfied the executive’s need for liquidity and cost of capital benefits”. These findings are echoed through many of the cases discussed below.

5.3 Research methods

We have specifically chosen to study financial instruments disclosures for three key reasons. First, there has been a call for more research in the area of risk reporting (Beretta and Bozzolan, 2004) and, in particular, derivatives risk reporting (Wang et al., 2005; Seow and Tam, 2002). Second, because long-standing mandatory disclosure tends to be static, uniform and ultimately ‘boiler-plate’. By contrast, financial instruments disclosures are complex, non-uniform and the introduction of new rules in IFRS 7 produced significant first-year adoption differences.131 Third, we examine financial instruments disclosures because a number of researchers have already found them to be value relevant (Barth et al., 1996; Skinner, 1996; Venkatachalam, 1996; Seow and Tam, 2002; Wang et al. 2005). These findings contrast with the mixed results of studies of the value relevance of non-financial risk disclosures.

To enable us to identify voluntary disclosures over and above the requirements of the Standard we designed a disclosure checklist based on the requirements of IFRS 7. This checklist is comprehensive and is absolutely dependent upon the Standard’s mandated requirements. Any discrepancies which might arise between our checklist and those used by the Big Four will be due to conditional responses. We took every

131 Particularly for those firms issuing 31.12.2007 annual reports.
precaution to ensure that our checklist was not materially different from those produced by any of the Big Four audit firms as these audit firms were responsible for the audit of all firms within our sample. The annual report of each company was reviewed manually and alongside a compliance review we also noted significant areas of disclosure where firms reported more detail than the Standard required. In total there were 133 returnable responses spread across 5 categories. Table 14 provides an outline of the checklist categories.

In total 66 firms were reviewed for the purposes of this study. As this is an extremely time-consuming process, we limited our sample to the FTSE 100 non-financial IFRS 7 compliant firms as at 13 October 2008. Of the FTSE 100, at the time of data collection 12 firms had not adopted IFRS 7 due to the timing of their year-ends and the other 22 excluded firms were financials. Any firms publishing annual reports after this cut-off date have been omitted because firms could have early adopted major proposed IFRS 7 amendments and therefore these firms’ disclosures might be different to those of our existing sample and thus risk skewing the disclosure index results.

The sample was chosen because, by nature of their size, these firms have the greatest exposures to risk and thus are the most likely firms to engage in derivatives usage and trading. The size of our sample exceeds those taken in many prior studies of this type. Though a larger sample size might be desirable, we believe that the sample size provides adequate coverage of all identified parameters, themes, and codes.

As the coding was undertaken solely by one person the typical reliability issues associated with content analysis – stability, accuracy and reproducibility – outlined by Krippendorff (2004) are less problematic than if several researchers had coded the data. To further mitigate against the problems identified by Krippendorff, two financial reporting experts undertook a coding exercise for 10 of the sample companies. The results of this sensitivity analysis were largely identical to those

132 Amendment to IFRS 7 for disclosures relating to reclassifications of financial assets – effective date 1 July 2008.
133 See for example: Street, Gray and Bryant, 1999 (49 companies); Elmy et al., 1998 (33 companies); Lopes and Rodrigues, 2007 (56 companies); Bhamornsiri and Schroeder, 2004 (30 companies)
undertaken by the first coder and no material differences were found between the two. This indicates that the results of the coding exercise are robust. One limitation of this type of research is that there is an element of subjectivity in the coding that by definition implies that there is no guarantee of achieving identical results if one replicated the study.\textsuperscript{134} However, the checks performed both indicate and seek to ensure the consistency of coding standards.

Content analysis has many different forms and has regularly been adopted as a qualitative approach for undertaking accounting research. More often than not, accounting researchers have opted to analyse the annual report and financial statements as the primary document as it is widely distributed, it holds a high degree of credibility (Tilt, 1994) and there is a greater level of completeness and consistency which differentiates it from other forms of corporate communication (Gray, Kouhy and Lavers, 1995). Although a focus solely on the annual report has drawbacks (Unerman, 2000: 670–672; Abraham and Cox, 2007: 235–237), content analysis continues to be popular provided that these constraints are both acknowledged and, where possible, worked around.

Smith and Taffler (2000: 627) categorised content analysis into two generic approaches: ‘form-oriented’ and ‘meaning oriented’. The former relates to measuring the quantity of words whilst the latter focuses on the underlying themes in the observed texts. A variety of approaches have been used to address concerns primarily of impression management and legitimation. These include: analyses of positive/negative keywords and phrases; analyses of readability using indexes such as the Fog Index and Flesch Index;\textsuperscript{135} analyses of rhetorical strategies; analyses of readability and linguistic styles using manual and computerised coding; analyses of other presentational techniques and visual images including graphs, tables, diagrams, pictures and the use of colour. In addition, these methods are sometimes used in combination with each other.

\textsuperscript{134} See Milne and Adler (1999) for further discussions of this coding reliability issue.

\textsuperscript{135} However one should note the concerns over applicability (Courtis, 1998; Jones and Shoemaker, 1994 [pp.164–165])
There have been many analyses of the quantity\textsuperscript{136} of corporate disclosures which have employed content analysis to investigate both voluntary and mandatory sections of the annual report and financial statements. Those interested in quantity have measured the number of words (Deegan and Rankin, 1996), the number of sentences (Buhr, 1998; Tsang, 1998), the number of pages (Cowen \textit{et al.}, 1987; Deegan and Rankin, 1996), the percentage of pages (Adams \textit{et al.}, 1995; Guthrie and Parker, 1990), and the percentage of total disclosure (Trotman and Bradley, 1981). More recently, measures have been developed to assess the quality of disclosures (Berretta and Bozzolan, 2004), particularly social and environmental disclosures, however it should be noted that this latter area of research continues to provoke great debate because it remains difficult to define.

A further stream of content analysis research has used checklists. There are two significant branches to the checklist approach. Firstly, studies have looked at the annual report from an audit compliance perspective whereby compliance with accounting standards is measured using a checklist based on the mandatory regulation. Compliance review commentators then report specifically on areas of non-compliance often proposing explanations for these errors, oversights or deliberate omissions. Amongst these prior studies there are several which have found significant areas of non-compliance in relation to financial instruments reporting requirements (Elmy \textit{et al.}, 1998; Roulstone, 1999; Bhamornsiri and Schroeder, 2004; Bamber and McMeeking, 2010). The second branch has sought to develop checklists in order to investigate hypotheses often associated with empirically testing theoretical underpinnings such as legitimacy theory and impression management but also testing determinants of voluntary and mandatory disclosures (Scott, 1994; Cormier and Magnan, 2003; Chalmers and Godfrey, 2004; Leventis and Weetman, 2004; Linsley and Shrives, 2006; Abraham and Cox, 2007; Lopes and Rodrigues, 2007).

Our work ties in closely with the checklist approach. We have used content analysis and effectively undertaken a compliance review in the same manner as many prior audit compliance studies, however in this study we have not commented on areas of

\textsuperscript{136} Often used as a proxy for quality.
non-compliance. Instead we have identified specific areas where firms have provided more detail than mandatorily required. To the best of our knowledge this is the first study of its type and provides a fresh approach to the usage of content analysis and also the analysis of theoretical explanations for corporate disclosure.

5.4 Results

We found that a number of firms have voluntarily disclosed information over and above the Standard’s requirements that is either significant by quantity or significant in terms of nature and perceived usefulness. We classified a disclosure as being consistent with legitimacy if the financial reporting practice related to a specific, normally one-off, transaction or event and sought not to mislead but instead to set this transaction or event within the boundaries of social expectations. The results indicate additional disclosures in excess of the requirements of IFRS 7, which we contend, on the balance of most likely outcomes, are consistent with a legitimacy strategy.

Our findings are structured as follows: first, we analyse two specific cases of firms providing additional disclosures in excess of IFRS 7 (Section 5.4.1 & 5.4.2); second we identify examples of firms within two groups who make additional disclosures – those who hold financial instruments in the category ‘Held For Trading’ (Section 5.4.3) and those who use hedging terminology without hedge accounting per IAS 39 (Section 5.4.4).

5.4.1 AMEC’s interest rate risk management policies

IFRS 7 requires a company to disclose the objectives, policies, processes and management of market risk, of which, interest rate risk is more often than not a key risk. AMEC discloses that it has not hedged against longer term interest rate risk. The financial instruments note reports that this was an unusual year for the company because of the disposal of a portion of their non-core business. These disposals

---

137 Perceived usefulness is a subjective property. The perspective that was used to gauge the usefulness was through the eyes of a sophisticated user of financial information. In effect, the question asked was – ’would the stakeholder’s perception of the position, performance, transaction, issue or decision taken be influenced with (or without) this extra information’. Thus, in many ways, the perceived usefulness is closely tied to materiality – see section 4.1 for definition.
generated a large cash surplus which remained unspent at the end of the year. The balance sheet reports cash and cash equivalents of £734.1m (40.4% of total assets; 2006: £375.4m; 20.6% of total assets). The acquisitions and disposals note reports cash received from the disposal of discontinued operations to be £391.5m (profit: £292.4m) and cash received from the disposal of a subsidiary (AMEC SPIE) to be £684.3m (profit: £311.5m) thus in total generating £1,075.8m. The financial instruments note continues: “the group intends to reinvest these monies into core operations and return up to £80 million to shareholders via the previously announced share buyback”. The note concludes by asserting that this policy (of not hedging interest rate risk) will be “kept under review”.

The qualitative market risk disclosure requirements related to interest rate risk as mandated by IFRS 7 would have been met by less detailed disclosure by AMEC. Instead the note provides much greater detail by affirming that the firm “intends” to use the majority of this cash surplus to fund “core operations” and a smaller proportion to honour a “previously announced” share buyback.
<table>
<thead>
<tr>
<th>Categories</th>
<th>Number of questions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(1) BALANCE SHEET</strong></td>
<td></td>
</tr>
<tr>
<td>Categories of financial assets and financial liabilities</td>
<td>8</td>
</tr>
<tr>
<td>Financial assets or liabilities at fair value through profit or loss</td>
<td>8</td>
</tr>
<tr>
<td>Reclassification</td>
<td>3</td>
</tr>
<tr>
<td>Derecognition</td>
<td>4</td>
</tr>
<tr>
<td>Collateral</td>
<td>5</td>
</tr>
<tr>
<td>Allowance account for credit losses</td>
<td>1</td>
</tr>
<tr>
<td>Compound financial instruments with multiple embedded derivatives</td>
<td>1</td>
</tr>
<tr>
<td>Defaults and breaches</td>
<td>4</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>34</strong></td>
</tr>
<tr>
<td><strong>(2) INCOME STATEMENT AND EQUITY</strong></td>
<td></td>
</tr>
<tr>
<td>Items of income, expense, gains or losses</td>
<td>10</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>10</strong></td>
</tr>
<tr>
<td><strong>(3) OTHER DISCLOSURES</strong></td>
<td></td>
</tr>
<tr>
<td>Accounting policies</td>
<td>10</td>
</tr>
<tr>
<td>Hedge Accounting</td>
<td>12</td>
</tr>
<tr>
<td>Fair Value</td>
<td>16</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>38</strong></td>
</tr>
<tr>
<td><strong>(4) NATURE AND EXTENT OF RISKS ARISING FROM FINANCIAL INSTRUMENTS</strong></td>
<td></td>
</tr>
<tr>
<td>Qualitative disclosures – credit risk</td>
<td>6</td>
</tr>
<tr>
<td>Quantitative disclosures – credit risk</td>
<td>1</td>
</tr>
<tr>
<td>Qualitative disclosures – liquidity risk</td>
<td>6</td>
</tr>
<tr>
<td>Quantitative disclosures – liquidity risk</td>
<td>1</td>
</tr>
<tr>
<td>Qualitative disclosures – market risk</td>
<td>6</td>
</tr>
<tr>
<td>Quantitative disclosures – market risk</td>
<td>1</td>
</tr>
<tr>
<td>Quantitative disclosures – other risks</td>
<td>4</td>
</tr>
<tr>
<td>Further credit risk disclosures</td>
<td>9</td>
</tr>
<tr>
<td>Further liquidity risk disclosures</td>
<td>8</td>
</tr>
<tr>
<td>Further market risk disclosures – Sensitivity analysis</td>
<td>7</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>49</strong></td>
</tr>
<tr>
<td><strong>(5) ADOPTION AND EXEMPTIONS</strong></td>
<td></td>
</tr>
<tr>
<td>Early adoption</td>
<td>1</td>
</tr>
<tr>
<td>Exemption from preparing comparative information</td>
<td>1</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>2</strong></td>
</tr>
<tr>
<td><strong>TOTAL MAXIMUM RETURNABLE CHECKLIST RESULTS</strong></td>
<td><strong>133</strong></td>
</tr>
</tbody>
</table>
Details of a £100m buyback were presented by the newly appointed Chief Executive on 13 December 2006, at the same time as announcements were made about the future strategy and vision for AMEC, which included some details related to the disposal of non-core businesses. For a time the buyback appeared to be indefinitely stalled but this position changed during 2007 after the disposals of its construction businesses were completed and it again seemed possible. However, by the end of the financial year (2007) the buyback had still not taken place and thus this reference to £80m in the audited section of the financial statements confirms AMEC’s intention to honour the promise (but not to its full value). The share repurchase agreement was eventually approved on 13 May 2009 at the AGM. However, reference to the previously announced buyback of £100m was omitted from the 2008 annual report.

It is difficult to measure how much of the cash that was generated through the disposals during 2007 was used in the reinvestment in core activities proposed. Though acquisitions were made during 2008, the consideration paid for these was not significant nor out of character with previous periods.\textsuperscript{138} In addition, a disposal was made during 2008 which generated more cash than was spent on all the other acquisitions put together.\textsuperscript{138} During 2008 AMEC recorded revenue increases of 10.5% (£248.2m) against 2007 figures, a gross profit margin increase of 26% (£65m) and a net profit margin increase before amortisation and exceptional items of 64% (£80.9m). The improved reported profitability was matched by an increase in net assets of 10.7% (£95.2m), of which non-current assets accounted for £103.3m, the majority of which related to the goodwill arising on the acquisition of subsidiaries (£84.7m).

If the cash generated by the disposals of non-core businesses during 2007 has been reinvested, as was the specified intention, then it is difficult to identify where this money has been spent. The argument is strengthened by the fact that the cash and cash equivalents balance rose by £30.5m to £764.6m by the 2008 balance sheet date.

\textsuperscript{138} Material acquisitions during 2008 amounted to £75.4m of cash (excluding deferred payments). Immaterial acquisitions were made which amounted to a spend of £16.4m cash (2007: £3.1m). A further £5.2m was invested in joint ventures and other investments (2007: £6m). An acquisition was made during 2007 and reported in 2008 for £12.6m.

\textsuperscript{139} Cash received £139m (profit: £110.7m)
The reference to the hedging of interest rate risk disclosure in the financial instruments note in the 2008 annual report reads simply: “The group remained in a net cash position throughout the year. As a result, long-term interest rate hedging... is not considered appropriate. However, as UK interest rates have fallen steadily this will have an impact on interest income in 2009.”

As is common amongst the FTSE 100 firms, the financial instruments note is cross-referenced to the treasury risk section of the annual report which is placed outside of the audited financial statements. The interest rate risk management section of the comprehensive treasury risk management narrative acknowledges that the normal policies and processes adopted towards interest rate risk management have been altered as a result of having a cash surplus. AMEC reports in this section that the cash surplus was “temporary” and therefore the surplus was not hedged (unlike if it was seeking to minimise downside risk from borrowings).

AMEC continues this section with an interest rate sensitivity analysis that states: “a one percent movement in rates on the 2007 average cash balance of £435m would impact interest income by £4.4m”. In fact, the cash balance has stayed above £600m during the period 1 January 2008 to 31 July 2009 and equally, during the same period, LIBOR has decreased from 5.5% to 0.5%.\(^\text{140}\)

It could be argued that by choosing not to hedge, AMEC were speculating on interest rates and thus one might contend that these extra disclosures were intended to legitimise their actions. Risk can be both upside and downside and though empirical analysis has suggested that hedging could lead to wealth destruction rather than creation, it is commonly held that macroeconomic risks, such as interest rate risk, should be hedged particularly where companies do not have the requisite and specialist knowledge to trade. There are reasons why an entity might choose not to hedge using financial instruments (for example the exposure is managed through other means; public perceptions of the entity using financial instruments; management capabilities and their knowledge restraints; the costs of establishing

\(^\text{140}\) Bank of England statistics
and maintaining a derivatives programme; the difficulties in pricing instruments accurately; and the financial reporting demands – including significant concerns regarding the disclosure requirements [for further details see Bodnar and Gebhardt, 1999 and El-Masry, 2006]) but given the materiality of the balance under review, social norms suggest that the upside and downside risk should be hedged however AMEC did not adopt this practice. The additional disclosures in excess of IFRS’ base requirements allow AMEC to justify its policies and to legitimise its risk management practices. We are not suggesting that AMEC is distorting the situation or misleading users but simply trying to explain the rationale behind the decision not to hedge. In other words, the cash was most probably intended to be spent and not held as a long-term cash reserve to effectively bet against the money markets.

5.4.2 British American Tobacco: detailed derivatives disclosures

British American Tobacco (BAT) has elected to report their qualitative and quantitative financial instruments disclosures in distinct sections meaning that there is a note dedicated to derivative financial instruments and it is within this note that BAT makes the voluntary disclosures. The firm has provided seven pages of detailed quantitative derivative financial instruments disclosures whose level of detail exceeds the requirements of IFRS 7.

Finer examination shows that during 2007, BAT has recognised the largest annual loss on derivative financial instruments held at fair value and not held in hedge accounted relationships of our 66 sample firms (£181m; 5.9% of PBT). During 2008, the losses arising on derivatives not held in hedge accounted relationships increases to £578m (15.6% of PBT), which was again one of the largest reported losses in our sample.

In addition to the aforementioned level of disclosure, these losses are also presented in what could be considered a potentially misleading manner. The losses are reported as being part of a sub-category of movements within the net finance costs note named ‘fair value changes’. The derivatives losses are almost perfectly set off in 2007 and 2008 by these seemingly associated ‘exchange differences’ leaving the
fair value changes gains and losses as immaterial. On further investigation we note that the majority of the derivatives held by BAT are currency-related, comprising mainly currency swaps but also forward foreign exchange contracts, however the offset is not necessarily perfectly correlated with the movements on the derivatives as implied by the presentation of this set-off.

An observer might note that BAT appears to be keen to stress that the derivatives are not formally hedging instruments per IAS 39 but there are off-setting gains and losses. In other words, a case could be made that the reader is being asked to believe that the firm is not speculating. On balance, it seems that legitimation is the most likely reason for the following strong wording in the financial review: “Clear parameters have been established, including levels of authority, on the type and use of financial instruments to manage the financial risks facing the Group. Such instruments are only used if they relate to an underlying exposure; speculative transactions are expressly forbidden under the Group’s treasury policy.”

As stated above, it is not possible for us to conclude that this extra disclosure is, or is not, useful however it is provided to us in excess of the Standard’s requirements and thus, in the context of our study, calls for an explanation. It would appear most likely that the reason for these extra disclosures is that they act as a legitimation device to construct a rationale for the large derivatives losses.

Thus the theoretical framework would indicate a case of organisational legitimacy as the company is adding voluntary disclosures to legitimise risk management strategies and derivatives usage which are the norm for companies of this nature and size. This is a situation where the mandatory disclosures alone do not enable the company to fully explain justifiable bad news disclosures (such as the losses) and therefore there are additional voluntary disclosures.

It should be noted however that there could be a secondary motivation underpinning a segment of this disclosure. One could claim that the way that the numerical

---

141 Total derivatives related losses in 2008 were £521m (2007: £143m) and the exchange differences are recorded as £534m (2007: £145m). Thus leaving a gain in 2008 related to fair value changes of £13m (2007: £(2m))

142 Although we note that this is not repeated in the audited financial statements.
disclosures of the off-setting positions are presented indicates a willingness on the part of the company to mislead the reader. Though it would be inappropriate to say that this provides overwhelming evidence of impression management, given materiality levels (in both nature and size), it does appear to be a separate issue to the legitimacy argument that could be put forward. One analyst (interviewee 8) noted: “it’s just big lies, companies pretending that you’re giving out more – ‘oh, yes we’re giving more disclosure, and it’s complete’ – well it doesn’t, it just obfuscates and it contaminates other data as well.” We believe that this goes some way to corroborating Adams’ (2008) commentary that it is difficult to disaggregate instances of impression management and legitimacy theory unless one takes account of the broader context as we have tried to do throughout this study.

5.4.3 Financial Instruments held for trading

It would be natural for less sophisticated users of financial information to presume that firms who have derivatives classified as held for trading are engaged in activities associated with market speculation. However, our findings are not consistent with this hypothesis. In many cases there is no evidence of a materially significant distinct revenue generating unit from derivatives trading operations. It would appear that many firms use this classification as a suspense account when they have nowhere else to classify the instrument(s). Normally, when derivatives don’t meet hedge accounting rules they then become classified as held for trading. In almost every case the firm holding derivatives for trading states that they do not use derivatives for speculation purposes.

However some firms report material gains and losses from derivatives classified as fair value through profit or loss\(^ {143} \) but the phraseology is difficult to interpret and appears to be intended for a select audience who have private knowledge about the day-to-day operations of the firm. On the other hand, there are other firms who seek to absolutely clarify that the derivatives classified as held for trading are not actually used for trading\(^ {144} \). United Utilities, for example, report their held for trading gains and losses in the finance expense note as ‘Held for trading derivatives – economic

\(^ {143} \) For example Royal Dutch Shell, Scottish and Southern Energy, Tui Travel and Vodafone.

\(^ {144} \) For example Rio Tinto, Tesco and United Utilities.
hedge’ whilst Rio Tinto’s accounting policies state (p.135): “Rio Tinto does not acquire or issue derivative financial instruments for trading or speculative purposes; nor does it believe that it has exposure to such trading or speculative holdings through its investments in joint ventures and associates.”

There are firms on the other hand who hold derivatives for trading and either generate separately classified revenues from those operations or disclose that the intention for these derivatives is speculative. It is clear from their respective market capitalisations that these firms are amongst the market leaders in their industry and therefore probably best placed to trade on their own information. In each case these firms have high quality disclosure and also disclose more information than IFRS 7 requires both qualitatively and quantitatively. They all disclose a large volume of information related to risk management policies, processes and management and they all have separate sections devoted to their derivatives containing information in excess of IFRS 7’s requirements.

Interestingly, BP stated that they have “a well-established entrepreneurial trading operation that is undertaken in conjunction with [derivatives based risk management operations] using a similar range of contracts”. International Power disclose a comparable activity and they report that “derivative financial instruments are only used for hedge accounting purposes apart from energy based future contracts some of which are used for proprietary trading purposes” (p.111, emphasis added).146

Organisational legitimacy theory provides us with a theoretical platform from which to view these disclosures. Companies who categorise derivatives as held for trading have generally sought to achieve one of two ends in their disclosures: first, to reassure investors that they are not speculating as this is not their principal business; or second, to ensure investors understand that they are in a privileged position given their access to information and that trading on this information is “acceptable behaviour” (Dowling and Pfeffer, 1975: 122). Consistent with Branco and Rodrigues (2008) it seems that firms are legitimising derivatives trading operations by releasing fuller than mandated information. We agree with Branco and Rodrigues’ statement

145 i.e. a section dealing with financial risk and another dealing with the derivatives separately
146 This is an immaterial balance in 2007
that "legitimacy requires a reputation that must be retained" (p. 165). If these firms are to retain their primary trading reputation then they must legitimise this secondary trade. Thus, legitimising derivatives trading\footnote{And more specifically the associated gains and losses from these trading activities} seems to be a priority for the firms described above.

5.4.4 The use of (derivations of) the word hedg- amongst those who do not employ hedge accounting per IAS 39 – evidence supporting legitimacy theory

Prior research has considered the effects of communication strategies on perceptions of risk (for example Hodder \textit{et al.}, 2001; Weber \textit{et al.}, 2005). More specifically, experimental studies focusing on perceptions of risks in the field of derivatives usage (Koonce \textit{et al.}, 2005a; 2005b; 2006) found that the perceptions of potential investors could be altered when certain terminology was used. When phraseology such as ‘hedging’ was used in relation to derivatives there was the perception that the transaction carried less risk. Therefore, we analysed the disclosure for those firms who did not hedge account during the period under review but still used derivations of the word ‘hedg-’. In total, four firms fall into this category. Kazakhmys uses the word hedging 14 times, Liberty International (Liberty) uses the word 15 times, Shire uses the word 13 times and Cadbury Schweppes (Cadbury) uses the word 65 times.

5.4.4.1 Kazakhmys

Each of the 14 references to hedging in Kazakhmys’s 2007 annual report relate to ‘natural’ hedging or operational hedging. Though there are those who dispute this, textbook theory holds that shareholders and other stakeholders are rational and risk averse. In direct contrast to this presumption the annual report of Kazakhmys states that “the Directors do not consider it to be in the interests of the shareholders to reduce the Group’s exposure to commodity price fluctuations. The only commodity hedging carried out is that performed by [a subsidiary] in order to mitigate the risk of an increase in the purchased cost of copper cathode, where natural hedging is not available.” A reader of the accounts might infer that by refusing to hedge the firm is
essentially speculating and the directors do not conceal this fact, but instead celebrate it as a selling point. The annual report states that this policy of not hedging “enabl[es] investors to fully participate in price movements through the commodity cycle”. Kazakhmys acquired a power station that it feels “provides a hedge against rising power prices for [their] own future needs”. Kazakhmys’s management do not hedge currency risk but instead “where possible develop… local currency revenue streams to provide a natural hedge.”

Other principal financial risks also go unhedged. There is no mention of interest rate risk management via hedging instruments. On investigation it might be that this is deemed unnecessary because the firm is in a cash surplus position however (see observations above re. AMEC [Section 5.4.1]) this is also a form of speculation. No reference to unhedged balances is supported by quantitative data and there is no indication of the cost (benefit) attached to the policy. Finally, the annual report states that if necessary then they will consider hedging provided that the directors see it as a cost-efficient strategy.

We cannot be sure that Kazakhmys is concealing any information or simply seeking to manage it’s reputation. Instead it appears most likely that this proprietary information is intended to legitimise its position. Kazakhmys may be attempting to set its behaviour within the context of external expectations. The firm may not have attempted to manipulate external impressions in any way but may be appealing to certain types of shareholder.148 In Section 5.2 we noted that many commentators dismiss institutional legitimacy as a key theoretical explanation for disclosure practices (amongst our sample of firms) however, given this disclosure produced by Kazakhmys, we believe that this might be an example. Institutional legitimacy “deals with how organisational structures as a whole… have gained acceptance by society at large” (Tilling and Tilt, 2010:57). The disclosure highlights a motivation for their policies and practices to be accepted by current and potential investors.

148 This might explain the volatility in the share price which shows a current 52 week range (18 January 2009 to 19 January 2010) of 574.50 – 1,558.00
Liberty uses currency and interest rate swaps to hedge interest rate risk and foreign exchange risk. The financial review reveals that interest rate risk is a key risk and states that the firm will mitigate the risk in the following manner: “Group policy [is] to eliminate substantially all exposure to establish certainty over long-term cash flows. Hedging.” However the accounting policies state that “the group does not apply hedge accounting to its interest rate swaps”. Of the 15 recurrences of derivations of the word ‘hedge’ in the 2007 annual report, nine of them refer to an accounting policy for hedge accounted transactions of which there are none, five refer to an intention to hedge account and only one makes mention that no hedge accounting has taken place. As stated in section 1.6.6.3, not all entities will choose to meet the hedge accounting criteria outlined by IAS 39 and some who meet the criteria will choose not to hedge account. Nevertheless, the company appears to be extolling the virtues of an accounting system – namely, hedge accounting – that it does not employ. Investors need to be aware that derivatives gains and losses will be charged against profits when they arise rather than being smoothed under hedge accounting and therefore one could argue that there is a hint of obfuscatory behaviour in the multiple disclosure of the phrase ‘hedge accounting’.

Shire outlines in it’s accounting policies the accounting procedures it would follow if instruments had been hedge accounted within the section entitled ‘Accounting for derivative financial instruments and hedging activities’. However within this same section it notes: “in either the current or prior period the Group has not designated any of its derivatives as a hedging instrument and therefore none of the Group’s derivatives qualify for hedge accounting.”

Shire states in the financial instruments note that it uses “derivative financial instruments to economically hedge certain risk exposures” but states that most foreign exchange exposures can be managed “through natural hedging via the currency denomination of cash balances”. This disclosure is subsequently qualified and made credible by quantitative data. The note also states that the directors do not
feel they need to manage interest rate risk because the firm “maintains all of its investments on a short-term basis”.

Shire has not adopted hedge accounting however it does have a reputation to maintain and therefore provides clear explanations of it’s behaviour. One might contend that there is an element of legitimisation of policies and processes in the reference to interest rate and foreign exchange risk but this is part of a broader context in that Shire clearly shows what it would do if exposures were larger and if it had a greater need for hedging instruments and hedge accounting rules. Shire’s disclosure appears full and appropriate and there is no evidence of a willingness to deliberately mislead and therefore there is no evidence of impression management.

5.4.4.4 Cadbury

The following extract captures the essence of Cadbury’s hedge accounting disclosures:

“We seek to apply IAS 39 hedge accounting to hedge relationships… where it is permissible, practical to do so and reduces overall volatility. Due to the nature of our hedging arrangements, in a number of circumstances we are unable to obtain hedge accounting. We continue, however, to enter into these arrangements as they provide certainty of price and delivery for the commodities we purchase, the exchange rates applying to the foreign currency transactions we enter into and the interest rates that apply to our debt. These arrangements result in fixed and determined cash flows. We believe that these arrangements remain effective economic and commercial hedges.”

There are no quantifications of the effects on the accounting numbers of not hedge accounting but there is a brief explanation of the accounting recognition rules for gains and losses immediately following this note.

The note states that “in a number of circumstances” hedge accounting has not been possible but this does not reflect the fact that we found no trace of any instruments being hedge accounted. It is not until the 62nd mention of the word ‘hedge’ that the
following statement occurs: “For 2007 no derivatives were hedge accounted for” however, somewhat confusingly there is a £3m negative reserve being carried forward related to hedging instruments from prior years with no movements occurring during the year. The note appears to attempt to legitimise the transactions by referring to the firm’s “economic and commercial” integrity and also speaks of them being “effective” hedges. However there appears to be no clear or robust substantiation to this claim. In the context of legitimacy theory, one could make a case that this is an attempt to muddy users’ interpretations with the intention to show that the behaviour during the year fits with an expected norm.

Given Koonce et al.’s (2005a) findings that perceptions can be manipulated with the use of certain phraseology it should be unsurprising that companies might seek to create or mould impressions by repetition of buzzwords such as ‘hedging’. It could be speculated that Cadbury’s frequent, and often irrelevant, references to hedging provides evidence of an impression management strategy. These are additional disclosures which seem to carry no substantive or proprietary information and therefore theoretically should serve some purpose.

It should be noted however, as Adams (2008) highlighted, that it is difficult to disaggregate impression management from legitimacy theory and when we look at some of the instances of repetition and the remainder of the financial instruments disclosures, it is also possible that the voluntary disclosures might be a device to legitimise and explain why the financial reporting policies and choices have been made. Also viewing disclosures through the lens of operational legitimacy it is possible to see why these extra disclosures are made especially when we note that hedge accounting has not been adopted despite holding £46 million of derivative financial assets and £22 million of derivative financial liabilities alongside making losses from financial instruments of £(14m) in 2007 (2006: gains of £19m).

---

149 An argument previously grounded in studies related to rhetoric and linguistics.
5.5 Conclusion

This study reviews an unusual disclosure concern. We have attempted to answer the questions: ‘do firms voluntarily disclose information in excess of the mandatory requirements; and if so why, when this information is costly to prepare (time spent and data availability) proprietary in nature, and competition sensitive?’ We find clear evidence of extra disclosures that exceed the requirements of IFRS 7. On the balance of most likely outcomes, there is also enough evidence to indicate legitimisation strategies despite the cost and private information concerns.

Prior work concerning voluntary disclosures has hypothesised, and found limited evidence, that bad news which must be reported causes a higher level of disclosure (Leventis and Weetman, 2004; Bloomfield, 2008; Li, 2008) particularly where the market is already aware of the bad news (Verrecchia, 1983) in order to avoid adverse selection (Grossman, 1981; Milgrom, 1981). We have found that this same pattern is mirrored in the domain of mandatory reporting. We found that unexpectedly high losses recognised on financial assets and financial liabilities classified as fair value through profit or loss, have been explained by firms in greater detail than is mandatorily required. There is the argument that this is an unsurprising finding as real and financial externalities, such as analysts and investors would, most likely, demand this information regardless as argued by Dye (1990) amongst others.

In line with many social disclosure studies, we found that in the majority of cases the nature and phraseology of the extra disclosures were aimed at protecting reputation and legitimising the policies, processes and management practices rather than to deliberately mislead investors (Chalmers and Godfrey, 2004; Bebington et al., 2008; Aerts and Cormier, 2009). We did note occasions however where legitimisation strategies and impression management strategies overlap. In addition, in line with prior disclosure studies, there were other occasions where the disclosure is made in such a way as it was intended to create an impression of an event, or even on occasion, mislead users of the financial information.

There are a number of limitations to this study. Firstly, we can only ever speculate as the underlying rationale is not publically available information. Using the
categorisation method outlined in Section 5.4 to differentiate between competing theoretical paradigms, our observations are grounded in the most likely motivations for voluntary disclosures. Secondly, it is complex and time consuming to identify areas where there is voluntary disclosure and hence, thirdly, this means that any study of this nature is going to have a small sample size until qualitative research software improves radically. As stated in Section 5.2, this sample size is comparable with, and in many cases is larger than, prior research. Fourthly, the small sample size and the relatively large number of voluntary disclosers within that sample make statistical tests of significance impossible to perform. Any significance results would simply be reporting endogeneity i.e. they would be self-referential. Fifthly, the small number of firms examined meant that scoring the quality of the additional information proved to be a non-starter, however helpful we believe this would have been. We do acknowledge that it might be possible to employ improved rhetorical and linguistic appraisal techniques to gain an even greater understanding. Therefore we believe that this is a lucrative avenue for future content analysis research. Sixthly, content analysis as a methodological approach suffers from certain weaknesses, amongst which is the difficulty associated with the generalisability of the findings. However, we have mitigated this concern by asking two senior researchers that were independent of the work to conduct reviews of a sample of the checklist results and the results were not materially different. Finally, though we have reviewed the prior and future period annual reports for all firms who voluntarily disclosed information for the year 2007/08, we have not reviewed all prior and post annual reports for the entire sample. It is our belief (i) that this would be time consuming, (ii) there is a propensity to ‘boiler plate’ disclosures on post-first time adoption periods and (iii) this would be problematic from a regulatory perspective, i.e. IFRS 7 only came into effect on 1 January 2007 and was updated and significant proposed amendments to the reporting of financial instruments could have been voluntarily adopted for post-sample financial reports.

Nevertheless, given the findings reported we hope that this study will spark new interest in reviewing other areas of financial reporting for voluntarily disclosed proprietary information. If, as the literature seems to suggest, the most used and useful document for analysts and investors is the annual report, and of the annual report, the most used sections are the financial statements and the notes to the
financial statements, then as disclosure researchers some of our focus might be
directed in this potentially rich area.
Introduction to Chapter 6

The previous two chapters have presented evidence of partial, non-, full or over compliance with the financial instruments disclosure requirements. The compliance review drew attention to areas of both incomplete and full compliance. In addition, a series of explanations are provided evaluating this disclosure behaviour. Following this, chapter 5 reviewed individual cases of disclosures being made over and above those required by IFRS 7 and sought to rationalise these disclosures based upon the individual context surrounding the relevant entities. This chapter builds on these previous two studies by attempting to determine the characteristics that drive levels of both compliance and quantity of disclosures. In addition, this chapter attempts to build a case for considering compliance as a proxy, in a mandatory reporting environment, for measuring the quality of disclosure.

On the basis that blind acceptance that quality and compliance are linked would be unsuitable. Therefore, this chapter develops this hypothesis and presents interview evidence, survey data and an analysis of comment letters (related to the financial instruments disclosures exposure draft) to assist in the appraisal of the above proposal. A survey instrument was designed and sent to key stakeholders related to the sampled entities asking questions over various aspects of the financial instruments disclosures. The primary motivation was to assess whether key stakeholders believed that the standard setters had written financial instruments disclosure requirements that provide decision making useful information and thus fulfil the quality objective. In addition, twenty semi-structured interviews were conducted and analysed based around this same theme. This extra evidence provides additional and needed reassurance that IFRS 7’s requirements are useful.

The regression results indicated that certain variables are statistically significant in determining the levels of disclosure. In the case of quantity it was found that lower levels of managerial ownership and higher levels of news/analyst following were statistically significant. It was found that higher levels of investor following, marketability, a new share issue during the year and a higher volume of derivative assets held were statistically significant to quality. These results do not find evidence of statistical significance in relation to variables which are typically associated with
the determinants of high quality (and quantity) of disclosures – such as size, cross listing or being audited by an elite firm. This is because the sampled companies are all of a critical mass. In other words, they are all large, cross-listed and audited by the Big Four.

The results challenge earlier arguments put forward by disclosure researchers, that quantity can be used as an appropriate proxy for quality. In fact, the determinants study suggests that, in the case of financial instruments disclosures, the reverse might be true, and that when quality is high, quantity is low and vice versa. These results are especially relevant for issues related to visibility, structure and performance related variables.
Chapter 6: The quantity and quality of reporting financial instruments under International Financial Reporting Standard 7 Financial Instruments: Disclosures

Purpose: This study answers calls from prior work to investigate in more detail risk reporting following the release of the mandatory reporting requirements captured in IFRS 7. The purpose of the study is to attempt to address Beyer et al.’s (2010) primary concern that the literature lacks a definition of disclosure and financial reporting quality and subsequently to explore the conclusion to Hasseldine et al.’s (2005: 247) work, which stated that “content analysis based on the mere volume of disclosures may be insufficient”. This study adopts the attitude that information usefulness is determined by quality not by quantity; thus, the challenge to measure the former, though theoretically problematic, is essential to an understanding of why and what standard setters should be requiring. The motivation for this chapter is threefold: firstly, to put forward a case for studying the mandatorily produced information and to suggest usable definitions for measuring its quantity and quality; secondly, to examine whether key stakeholders believe that the financial information produced by entities is of a satisfactory quality; and finally, to explore the determinants of disclosure levels in terms of quantity and quality, and subsequently further investigate the question of whether quantity and quality are synonymous, as prior work has often suggested.

Design/method/approach: This study links the results from the approach adopted in Chapter 4, where the financial instruments disclosures of the FTSE 100 non-financial IFRS 7 compliant firms were examined, and proxies this for quality. In addition, the quantity of disclosures is also measured. To substantiate the theory that the compliance results are an appropriate proxy, the comment letter feedback was reviewed and, alongside this, an ex-post review of key stakeholders’ attitudes towards IFRS 7 was undertaken which involved a combination of questionnaires and semi-structured interviews.

Findings: The interview and survey data indicate that IFRS 7 meets the perceived demands of the qualitative characteristics for key stakeholders and captures the concept of quality. The regression results show that the determinants of quantity and
quality differ. More importantly the study found that, in many cases, the directions of the variables determining levels of quantity and quality are in opposition.

**Originality/value:** This study looks at the quality problem through a new lens. For the first time, there is evidence that researchers who are using mandatory disclosures as primary evidence should look to measures of quality, rather than drawing conclusions based upon an acceptance that quantity is an appropriate proxy for quality.

**Keywords:** Disclosure quality; disclosure quantity; financial reporting

6.1 Introduction

The majority of prior studies have focused primarily on a voluntary reporting environment. Areas of mandatory reporting have been commonly overlooked as a context to consider the issue of disclosure quality – despite their obvious usefulness and importance to the users of the annual report. Traditionally, mandatory reporting has been seen as standardised, and in many cases ‘boiler-plate’. However, the requirements of IFRS 7 are guided both by rules and principles¹⁵⁰, and demand both quantitative and qualitative information of varying degrees, dependent upon the specific position and characteristics of the firm producing the disclosure. In addition, the disclosures reviewed in this study vary significantly, partly due to this being the first year of adoption of IFRS 7, and partly because of the specialist nature of companies’ financial risk management systems, policies, processes and management. These disclosures are difficult to homogenise and, even though it is not their role to do so, would be impossible for audit firms to prepare on behalf of the entity. These reasons have driven the findings that there are significant differences between levels of both volume and compliance within this sample.

Seeking a definition of a nebulous concept such as ‘quality’ is always going to cause debate (Botosan, 1997), and therefore it is unsurprising that within the context of

¹⁵⁰ For a discussion of the rules versus principles debate see section 4.4.1. Within this section is also some analysis of the compliance with hard rules-based, soft rules-based and principles-based requirements.
voluntary disclosure appraisals, the issue of quality continues to be actively
discussed (Berretta and Bozzolan, 2004). This definition problem has led many prior
studies to associate quantity with quality. Others have developed quality
measurement mechanisms based upon key attributes of what the authors believe
contribute to this concept (Berretta and Bozzolan, 2004 & 2007; Beattie et al., 2004).
This study explores whether, in a mandatory reporting environment, quantity is a
suitable proxy for quality, and suggests that in a mandatory reporting environment,
quality can be measured with greater confidence. One should remember that the
underpinning reason why quantity is being used as a proxy for quality is that
ultimately, quality is the primary determinant of information usefulness.

Despite reassurances of high quality auditing (McMeeking et al., 2004) and high
levels of reputational credibility (Francis and Wang, 2008), due to strict corporate
governance in the developed economies, researchers of mandatory disclosures
have frequently found compliance issues – including errors or omissions (in the area
of financial instruments: Elmy et al., 1998 [US]; Roulstone, 1999 [US]; Bhamornsiri
and Schroeder, 2004 [US]). In particular, US researchers have been critical of the
readability of the financial instruments disclosures. Bhamornsiri and Schroeder
(2004) concluded that the information produced was difficult to follow, lacked
uniformity, consistency, comparability and ultimately therefore decision-making
usefulness. In addition, Roulstone (1999) found that there were some major
compliance issues related to firms’ adoption of FRR 48.

This study puts forward the view that that non-compliance impacts negatively on the
observable quality of the information for the users. Thus there is a disagreement with
the proposal put forward by research such as Marston and Shrives’ (1991), that has
suggested that compliance was an indicator of the extent of disclosures but not the
quality. In fact the standard setting bodies provide clear guidance related to the
qualitative characteristics of information and allow the ‘users’ to feedback on them
and the standard setting process (see for example the International Accounting
Standards Committee Foundation (2008; updated 2010) Due process handbook for
the IASB which includes discussions of the standard setting process). As part of this
study, the comment letter feedback was reviewed and, alongside this, an ex-post
review of ‘users” attitudes towards IFRS 7 was also undertaken which involved a
A combination of questionnaires and semi-structured interviews. When a firm complies fully with a standard, then they have met the needs of the external audience and thus achieved the highest level of quality desired. In light of this, this work suggests that a suitable proxy for quality is compliance with the regulation.

This study, therefore, initially aims to establish suitable measures of financial reporting quantity and quality. Following this, the determinants of financial instruments reporting for these firms were investigated. Finally, the concept of whether quantity can be used as an appropriate proxy for quality as has been argued by many prior researchers was explored in more detail.

The remainder of the chapter is organised as follows. Section 6.2 presents an overview of the background to this study and a review of the previous literature related to disclosure quality. Section 6.3 outlines the conceptual framework and research methods adopted in the chapter. Section 6.4 presents and discusses the analysis of the perceptions of the quality of IFRS 7, whilst Section 6.5 presents and discusses the results of the determinants of financial instruments disclosures. Finally, Section 6.6 draws some conclusions and sets out the limitations of the study, alongside providing some areas and recommendations for further research.

6.2 Background and prior literature

6.2.1 Background

There has been a marked increase in the usage of financial instruments, and particularly derivative financial instruments, over recent years. The Bank for International Settlements triennial review of foreign exchange traded derivatives (2007) showed that the average daily turnover was at $3.2 trillion in April 2007.\textsuperscript{151} In comparison with April 2004, this represented an increase of 63\% at constant exchange rates. In addition, there has been a similar growth in the quantity of information disclosed about financial instruments in the annual report. On average, there was a 40\% increase in the volume of disclosure as compared to the period

\textsuperscript{151} The 2007 survey figures are shown here because the date for the adoption of IFRS 7 was 1 January 2007.
immediately prior to the adoption of IFRS 7\textsuperscript{152} for this sample. It was also noted that 4\% of the annual report is devoted to the derivative financial instruments and financial risk management note[s].\textsuperscript{153}

The idea that increases in disclosure are universally accepted or adhered to cannot be taken at face value. Accounting research has found that there is a potential relationship between reputational gains and non-financial disclosures (Bebbington\textit{et al.}, 2008). However, there is also evidence of a negative correlation between institutional ownership and levels of disclosure (Abraham and Cox, 2007), which suggests that investors prefer fewer risk relevant disclosures, rather than more. It has been argued that any prospective reputational gains need to be viewed in the light of the risk of less institutional investment for the disclosing firm (Milne and Chan, 1999). In addition, Bushee and Noe (2000) found that yearly improvements in disclosure rankings attract more transient, short-termist, institutional investors who are generally characterised by less desirable aggressive trading. Evidence has also provided explanations for a reluctance to disclose more, as research has shown that the amount of information disclosed decreases after litigation (Rogers and Buskirk, 2008), thus insinuating that management either erect an \textit{ex-post} shield or that there is an \textit{ex-post} re-thinking of a full disclosure policy.

The growth in usage of financial instruments has brought increased attention from analysts and commentators, some of whom are sceptical about whether these instruments are being used by firms for traditional risk management purposes or whether they are being abused or misused. The misuse might occur through either poor management, particularly of derivatives, or a lack of knowledge of how to manage them. El-Masry’s (2006) survey, for example, suggested a significant number of respondents would opt not to use financial instruments because they lacked the technical ability. The abuse might occur as a result of the asymmetric nature of the treasury management role within organisations. Sapra and Shin (2004), for example, reported that investors “imagine” firms are carrying large losses in their

\textsuperscript{152} This is for guidance purposes only as it would be very difficult to ensure a full adjustment to a like-for-like comparison.
\textsuperscript{153} Average 2,972 words; standard deviation 1,329; max 7,542; min 1,228. This is the word count of the note(s) to the financial statements regarding financial instruments and financial risk management as opposed to the operating and financial review, risk review, OFR, etc. This word count also excludes the accounting policies, trade receivables, non-current liabilities and finance costs notes.
balance sheets because it is difficult to ascertain if a firm has entered into speculative positions.

It is thought that misuse and abuse can be caused and, on occasion, exacerbated, by overly complex accounting standards. It has been argued that the standard setters have impaired the core qualitative characteristics of financial reporting (Woods and Marginson, 2004; Hernandez Hernandez, 2003). The IASB have always rejected this claim and Sir David Tweedie (2007, p. 7), the Chairman\(^{154}\) of the IASB, reassured listeners that accounting standards aim to allow firms to “tell it how it is”. In addition, these accusations appear to be somewhat misplaced and ignore the fairness of the standard setting due process\(^{155}\) (IASCF, 2008; updated 2010). Corporate annual reports are designed to provide relevant decision-making information that is a faithful representation of the firm’s position and performance in an understandable, comparable, verifiable and timely manner. The underlying accounting standards are developed and designed to aid the fulfilment of these qualitative characteristics. Therefore, where a stakeholder feels that the qualitative characteristics have been compromised, then the discussion period allows full and frank dialogue. Indeed, there is clear evidence that stakeholders do contribute to the standard setting process and their comments are often adjusted for (Cortese et al., 2009; McEnroe, 1993; Deakin, 1989; Puro, 1984).

6.2.2 Disclosure quantity and quality

There is a vast literature related to the purposes of firm-level information disclosure written from a theoretical perspective – as highlighted by prior studies such as those undertaken by Healy and Palepu (2001) and Verrecchia (2001). From a practical perspective, the purpose of mandatory disclosures set forth by the Framework is to ensure firms’ adherence to the qualitative characteristics. However, as stated by Beretta and Bozzolan (2004: 268), “risk disclosure is just becoming a serious topic for research” and there remains only a limited amount of work concerned with financial instruments disclosures which mandatorily require companies to provide an

\(^{154}\) The outgoing Chairman.

\(^{155}\) See chapter 7 for further consideration of this and conclusions from prior work about the fairness of the standard setters.
assessment of the “nature and extent of risks arising from financial instruments… and how the entity manages those risks” (IFRS 7, 1).

In terms of methodological approach, there has been a great deal of debate regarding whether disclosure-based content analysis should focus on quantity or quality (Beretta and Bozzolan, 2004; Beattie et al., 2004). Studies have recently subscribed to a position more in support of the latter than the former (Beretta and Bozzolan, 2007; Hasseldine et al., 2005; Beattie et al., 2004); however, this has not discouraged academics from pursuing quantity-based measures.

There have been many analyses of the quantity of corporate disclosures, and these have taken different forms, including reviews of: the number of words (for example see Deegan and Rankin, 1996; Deegan and Gordon, 1996; Neu et al., 1998); the number of sentences (Buhr, 1998; Tsang, 1998; Hasseldine et al., 2005); the number of pages (Cowen et al., 1987; Deegan and Rankin, 1996); the percentage of pages (Adams et al., 1995; Gray et al., 1995; Guthrie and Parker, 1990); and the percentage of total disclosure (Trotman and Bradley, 1981). More recent examples of quantity-based content analysis studies have counted the number of risk relevant sentences (Linsley and Shrives, 2006; Hasseldine et al., 2005; Salama, 2003; Milne and Adler, 1999). These studies argue that this is a justifiably superior measure to other quantity measures because of inherent identifiability and objectivity (Ingram and Frazier, 1980), and because sentences are a natural unit of written English (Hackston and Milne, 1996) and are thus easier to code (Linsley and Shrives, 2006). Prior work, such as that by Milne and Adler (1999), has provided an excellent critique of the importance of the unit of analysis, but broadly speaking it has been shown that whichever unit of measurement is used the results are more or less consistent (Hackston and Milne, 1996).

It is believed that sentences are less appropriate in measuring the quantity of mandatory disclosures because sentences in this context often do not obey standard grammatical rules, and are frequently fragments. In addition, measuring sentences

\[156\] It is interesting to note in this context that Linsley and Shrives (2006) have stated that they have ignored quality because they are investigating the nature of risk relevant disclosure, not the quality of it.
when dealing with narrative text only is relatively straightforward. However, when dealing with a combination of quantitative and qualitative disclosure, the measurement of sentences loses integrity. It is also noted that in the mandatory environment, a sentence can contain many or few items of disclosure, dependent upon the complexity of a position, and can range in length and significance dependent upon the incumbent information and the informational requirements.

Intuition tells one that, regardless of the unit of measurement adopted, quantity is a preferable research method because it is less subjective. It also benefits from being simpler to measure, especially with the advent of computer-based techniques, in terms of both time spent and technical accounting and auditing knowledge required.

Approaches to measurements of quality currently have two forms: externally administered survey data and research-led self-constructed measures of the attributes of quality. Two frequently used examples of external surveys are the Association for Investment Management and Research (AIMR) scores (Brown and Hillegeist, 2007), and the Standard and Poor disclosure transparency study (S&P) rankings (Daske and Gebhardt, 2006). However, reliance on such measures of quality assumes rankings are free from bias, and are credible and reliable (Healy and Palepu, 2001).

There are now numerous extant examples of weighted scoring indexes constructed by academics$^{157}$ (Singhvi and Desai, 1971; Botosan, 1997; Robb, Single, and Zarzeski, 2001), and equally there are now also alternative measures of narrative quality which are not burdened with the weaknesses of unidimensional weighted scoring systems, and the subjectivity of measurement inherent in their application (Beretta and Bozzolan, 2004 & 2008; Beattie et al., 2004$^{158}$). Beattie et al. (2004) for example, placed emphasis on five dimensions, including: a quantity dimension; a time dimension (historical, forward-looking and non-time specific information); a

$^{157}$ Beretta and Bozzolan (2007) have argued that these studies are quantity-based measures.

$^{158}$ Based on interviews conducted with analysts and other user groups, plus information produced by professionals in the areas of finance and accounting, including the Jenkins Report (AICPA, 1994), the SRI International (1987) survey, studies of the annual report undertaken by the Canadian Institute of Chartered Accountants (1991 & 2001) and similar studies by the Accounting Standards Board (2003).
financial dimension (financial versus non-financial information); and a dimension associated with the type of measure (quantitative versus qualitative information).

However, the weaknesses inherent in the weighted scoring models – reliability and validity – are still visible with these latter measures. In terms of reliability – or whether the results are consistently reproducible, accurate and stable (Krippendorff, 2004) – one surely harbours the same concerns, despite researchers protestations to the contrary (Beretta and Bozzolan, 2008). In addition, the validity problem still exists because any measure of this kind still requires the author to identify the diffuse and vast number of dimensions to quality that potentially exist. The second problem is summarised by Botosan (2004) in her discussion of Beretta and Bozzolan’s (2004) multi-dimensional quality measure, when she states that this index assumes that 

\[
\text{Quality} = f(\text{quantity, richness of content}),
\]

whereas quality has already been defined by the IASB as being \( f(\text{understandability, relevance, reliability, comparability}) \). It is difficult to argue these problems have been overcome in the revisited (Beretta and Bozzolan, 2008) model.

Determinants studies (see review in section 1.4) frequently use compliance with an index as the dependent variable. Several studies have defined financial reporting quality in terms of decision usefulness (e.g. Beuselinck and Manigart, 2007; Jonas and Blanchet, 2000) however very few have extended this idea to consider the qualitative characteristics as a proxy for reporting quality. Barth et al. (2008) use compliance as a measure on which to test variables such as earnings persistence. Hassan and Marston (2010) discuss compliance as one potential measure of quality in their overview paper. Weber and Cerbioni (2011) argued that measuring information quality according to the level of satisfying the qualitative characteristics was compelling. Dobler (2008) noted the failings of prior quality metrics\(^{159}\) and shows limited support for employing this type of measurement. All of these studies acknowledged the ongoing debate around this issue and that no measure of quality was without criticism.

\(^{159}\) Noting in particular the problems associated with using quantity as a proxy for quality.
The principal weakness of this quality metric was highlighted by Botosan (2004) when she argued that constructing a measure based on the qualitative characteristics would be extremely difficult in an empirical setting. However, a number of studies have attempted to address this problem. Jonas and Blanchet (2000), Lee et al. (2002) and McDaniel et al. (2002) develop instruments aimed at assessing each qualitative characteristic in order to assess information quality. These studies lack completeness though and focus on relevance and faithful representation. Bini et al. (2010), Dainelli et al. (2008), van Beest et al. (2009) and Dainelli and Bini (2011) took this issue forward by attempting to measure the level of fulfilment of the qualitative characteristics and thus rank the quality of financial information. Hooks and Staden (2011: 202) attempted to measure environmental disclosure by assessing “the relevance, understandability and comparability (with disclosures of other companies) of the information.” However, they noted that they “were unable to assess the reliability of the disclosures.” This project stops short of this approach (a checklist is not self-constructed) partly due to an acknowledgement of Botosan’s (2004) concerns about the difficulty of the task but also, more than this, because there is the intuitive underlying belief that the qualitative characteristics are captured within the accounting standards as a result of the fact that the stated objective of the IASB is to produce standards that provide decision making useful information and the factors that define this concept are the qualitative characteristics. Thus, measuring the compliance with the standard’s requirements should effectively proxy for measuring the decision making usefulness of the information provided.

In addition to exploring the case whether compliance is an appropriate proxy for quality, this chapter also examines the issue of quantity of disclosure separately and, unlike prior studies (e.g. Berretta and Bozzolan, 2004) does not incorporate a quantity measure into a quality paradigm. Instead, these two measures are considered independently.

6.2.3 Theoretical underpinnings

Hasseldine et al. (2005) followed up work by Toms (2002) when they sought evidence to support the hypothesis that environmental disclosure levels were related to corporate reputation. They found evidence that quality was a factor in reputation,
but quantity less so. This quality-signal approach suffers from the intrinsic weakness that it is difficult to disaggregate a disclosure related to reputation enhancement conclusion from other characteristics such as position, performance, industry and so forth. To unravel this within a mandatory reporting environment would further exacerbate this problem, and finding a credible and appropriate ranking system as a suitable proxy for corporate reputation (not associated with non-financial reputation) would be almost impossible. However, these conclusions are important and this chapter explores the finding that quantity is not always a suitable proxy for quality from a different perspective.

Other previous literature has shown that levels of corporate disclosures can be explained by many factors, including social and political context, legal and regulatory systems, and firm-specific characteristics, in addition to historical strategic and operational development and growth opportunities of both the company and the industry. There are several theories which seek to explain differences in levels of disclosure quantity and quality, amongst which are: impression management (see for example Leary and Kowalski, 1990; Bolino, Kacmar, Turnley and Gilstrap, 2008); agency and political costs (see for example Watts and Zimmerman, 1978, 1990; Milne, 2002); signalling (see for example Ross, 1977; Toms, 2002; Hasseldine et al., 2005); legitimacy (see for example Carpenter and Feroz, 1992, 2001; Tilling and Tilt, 2009); proprietary costs (see for example Dye, 1985, 1986, 1990; Verrecchia, 1983); and contingency theory (see for example Doupnik and Salter, 1995; Lopes and Rodrigues, 2007).

The purpose of this study is to investigate quantity and quality of disclosure and their inter-relationship. It could be considered that the quality signal is the outcome of the level of disclosure, but this is necessarily predicated by the original motivation of the disclosure quality or quantity. Therefore, it is possible to argue that a quality signal is desirable because it creates reputational gains, which in turn serve to reduce perceived risk and thus therefore the cost of equity (Botosan, 2006). However, the results do not always corroborate this explanation (Bushee and Noe, 2000). There is the possibility that a negative quality signal might be overlooked, and a positive quantity signal might be deliberately misleading.
6.3 Research methods

6.3.1 Qualitative methods: Content analysis; surveys; and semi-structured interviews

Content analysis has taken many forms. Prior accounting studies have focused on analyses of: positive/negative keywords and phrases (Hildebrandt and Snyder, 1981; Campbell, Craven and Shrives, 2002; Li, 2008; Bebbington et al., 2008); analyses of readability, using indexes such as the Fog Index (Li, 2008) and Flesch Index\textsuperscript{160} (Courtis, 1998); analyses of rhetorical strategies (Sydserff and Weetman, 1999; Aerts, 2001; Davison, 2008); analyses of readability and linguistic styles, using manual and computerised coding (Kohut and Segars, 1992; Sydserff and Weetman, 2002); analyses of other presentational techniques and visual images, including graphs, tables, diagrams, pictures and the use of colour (Davison, 2002; Courtis, 2004; So and Smith, 2004; Beattie, Dhanani and Jones, 2008). In addition, these methods are sometimes used in combination with each other.

The methodological approach for the chapter is a simple unweighted dichotomous disclosure checklist. The rationale is that the IASB have prescribed precisely what should be disclosed, and therefore a measure of quality is the level of compliance with the Standard. Ultimately, IFRS 7 was constructed to capture the qualitative characteristics of financial reporting as set out by the IASB, and to meet the financial information needs of investors.\textsuperscript{161} In addition, it has been found that regression results based on weighted indexes are significantly associated with their unweighted comparators (Firth, 1980; Adhikari and Tondkar, 1992).

An unweighted binary scoring system is operated, in which items are coded as follows: where the information is either disclosed (1); not disclosed but required (0); not required (N/A). Any weighting would introduce unnecessary lack of reliability issues into the study.

\textsuperscript{160} However one should note the concerns over applicability (Courtis, 1998; Jones and Shoemaker, 1994 [pp.164–165]).

\textsuperscript{161} Recent studies have also assumed this proxy for quality (Barth, Landsman and Lang, 2008).
The checklist adopted, based upon IFRS, included a maximum of 133 returnable results. After taking into account questions which were not applicable, the maximum available returnable result for any single firm was 98, and the minimum 61. The checklist mirrors checklists employed by the Big Four audit firms, who were responsible for auditing all 66 firms in this sample.

As discussed in Chapter 4 (Section 4.3), there are certain reliability issues which need to be addressed when undertaking content analysis of any kind. These issues are stability, accuracy and reproducibility (Krippendorff, 2004). As the coding was undertaken by one person these issues are less problematic; however, some subjectivity will always exist. Therefore, two experts in financial reporting were asked to undertake the coding exercise for 10 of the sample companies, and found there to be no material differences between their results and the results of the first coder.

Many studies have addressed the impact of corporate characteristics on the level of disclosure, using a content analysis-based checklist method. In their most basic form, checklists are reduced to single responses: ‘1’ complies; or ‘0’ does not comply (for example Tarca, 2004; Cuijpers and Buijink, 2005). These studies frequently look at a specific question: for example, is there a qualified audit report or has the company adopted IAS? A more advanced system which has emerged in recent years is to undertake a checklist to measure compliance and subsequently use this as the dependent variable (Tower, Hancock and Taplin, 1999; Street and Gray, 2001; Abd-Elsalam and Weetman, 2003; Glaum and Street, 2003; Chalmers and Godfrey, 2004; Lopes and Rodrigues, 2007). This avoids an overreliance on simple acceptance of reported facts, such as that a clean audit report means a company has fully complied with the accounting standards. This study falls into the latter camp.

---

162 See Appendix D to Chapter 4.
163 This is a Standard designed to be employed by all entities, including financial and non-financial firms. As financial firms have greater reliance, usage and complexity in their financial instruments dealings, many questions are targeted directly at them and they are deliberately excluded from my sample.
164 PriceWaterhouseCoopers; KPMG; Deloitte; Ernst & Young
165 I define ‘clean’ as not only unqualified but also free from any statements from the auditor which might indicate the firm had engaged in activities which were outside of normal reporting convention or normal operations.
Barth *et al.* (2008) assumed that the standard is the barometer of quality rather than an external artificially created measure, such as that constructed by prior researchers (for example Beretta and Bozzolan, 2004; 2008). This proposition was tested both *ex-ante* and *ex-post*. The comment letters were analysed first using QSR *International NVivo* to gauge general satisfaction levels with the nature and purpose of the Standard, and in particular whether it captured the qualitative characteristics positively or negatively. In total, over 245,000 words of text were analysed.

In addition the key stakeholders in the process were surveyed – standard setters, preparers, auditors and analysts (see analysis below).\(^{166}\) The sample was limited to those key stakeholders who were specifically involved with the firms whose annual reports were audited within this study. The survey asked them to comment on their perceptions of IFRS 7 in terms of the qualitative characteristics, alongside a number of other associated issues (full survey available in Appendix H). A standard five-point Likert scale was adopted, with 5 representing strong agreement and 1 representing strong disagreement.

Names, addresses and email addresses were collected using a combination of resources. This information was particularly hard to gather, and mainly involved visiting websites of the employers of these individuals. The survey was first mailed to all potential respondents (667) and included a stamped addressed envelope, but also gave a link to an online survey for those who preferred to complete the survey this way. Also included with each postal survey was a small return slip asking whether the respondent would be willing to undertake an interview. Of the posted documents, a small number were returned due to a change in address (47), leaving a potential maximum number of responses as 620. One month later, the revised sample, with the exception of those who had already responded, were posted the survey a second time, again providing a web link to the survey. One month after this, the survey was emailed (again with a web link) to those who had not responded (527). Of these, 134 emails bounced back as undeliverable. The crossover between the change of address and email bounce backs was high, and 92 further responses

\(^{166}\) A group of academics and students were also surveyed in a pilot project. However, these results have not been included in the analysis provided as it was felt that their responses were not appropriate in relation to the objectives of this particular study.
were deemed uncollectable. In total, 77 responses were collected and analysed. The 34 responses that indicated they could not reply should be deducted from the maximum possible return, thus reducing this total to 494.

Postal survey sample size 667
Returned as undeliverable (47)
Returned indicating that a response would not be appropriate or would not be possible (34)
Returned with a response (59)
Email survey sample size 527
Emails returned as undeliverable (92)
Further responses (18)

Total responses 77
Response rate (77/494) 15.6%

The original sample of 667 surveys issued and 20 interviews was broken down as follows:

<table>
<thead>
<tr>
<th></th>
<th>Questionnaires issued</th>
<th>Q’aire responses</th>
<th>Interviews</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comment letter respondent</td>
<td>106</td>
<td>14</td>
<td>1</td>
</tr>
<tr>
<td>Preparers include:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance director</td>
<td>66</td>
<td></td>
<td>5</td>
</tr>
<tr>
<td>Treasury director</td>
<td>38</td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>CEO</td>
<td>12</td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Investor relations</td>
<td>66</td>
<td></td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>182</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Analysts</td>
<td>361</td>
<td>63</td>
<td>8</td>
</tr>
<tr>
<td>Auditors</td>
<td>4</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>IASB</td>
<td>14</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Totals</td>
<td>667</td>
<td>77</td>
<td>20</td>
</tr>
</tbody>
</table>

The web link provided was different for each sub group, allowing an analysis of the responses for each of the user groups separately. It was not possible to disaggregate the preparers from the analysts as the researcher was aware of at least one occasion where the link was passed between interested parties. As no (0) auditors responded\textsuperscript{167} to the survey and only one standard setter replied agreeing only to an interview, i.e. no survey response, two broad categories were left, and this is how they are analysed: comment letter writers; and internal staff and analysts. Of this group, 20 people were subsequently interviewed: 15 allowed the interviews to be

\textsuperscript{167} Other than to say they do not respond to surveys.
recorded; 5 did not. Obviously there is an element of self-selection bias in this method; however, this is common and in this case unavoidable. A semi-structured interview technique was used which allowed the discussion to flow but remain focused (e.g. Bryman and Bell, 2007). The average interview length was 52 minutes (min: 27 minutes; max: 125 minutes). The recorded interviews were subsequently transcribed and analysed.

As ever, with any measure of quality, the definition set out in this chapter is fallible. In this case a problem arises due to the fact that a small number of firms have voluntarily disclosed information over and above the requirements of IFRS 7. It is difficult to ascertain on any index whether this information provides extra quality.

6.3.2 Hypothesis development

This study tests the various relationships between quantity and quality of disclosure, and certain key independent variables derived from prior theoretical and empirical studies. For the sake of convenience, ease of interpretation, and the provision of a greater insight, the starting point for this study into the determinants of financial instruments disclosures is an outline of the potential explanatory variables and the predicted direction of the associations between them and quantity and/or quality. The independent variables have been derived from research which has focused on the determinants of financial instruments usage; the determinants of financial instruments disclosures; the determinants of the levels of disclosure and adoption of accounting standards; and the determinants of the quality of voluntary disclosure. The directional expectations are derived from relevant theory and from prior studies. Table 15 summarises the independent variables. With the exception of the measures of quantity and quality, the independent variables mirror those used by past studies, and any adjustments have been explored.

Commonly, these variables have been classified into categories, namely: information costs; visibility; structure-related; and performance-related (Cormier and Magnan,

\[168\] A relative measure of quantity is employed in this project. The robustness tests included in the appendix substitute the actual measure into the regression analysis and though the results change, they are broadly consistent with those provided in section 6.5. \[169\] Adjustments such as taking logs or correcting for inflation.
1999 & 2003; Leventis and Weetman, 2004). To facilitate an ease of understanding and greater comparability with past studies, the same framework has been adopted.

6.3.2.1 Information costs and visibility independent variables

Information costs and visibility are strongly underpinned by two theoretical explanations: impression management and legitimacy theory. Prior research has found that these associations exist especially in the context of social and environmental disclosures, including CSR reporting.

Probably because of the asymmetric nature of treasury management, financial instruments disclosures have been generally found to be value relevant (Wang et al., 2005; Venkatachalam, 1996). Thus, one would expect that stakeholders would derive greater benefits where disclosure quality is high due to a reduction in information asymmetry. In addition, the stakeholder should penalise low quality disclosure as they require compensation if they are required to undertake investigations because of incomplete information. Leventis and Weetman (2004) found evidence of this, and this links to prior research which found, in a partial disclosure equilibrium, the observed share price reduced to reflect the potential for undisclosed bad news (see for example Lang and Lundholm, 2000; Skinner, 1994). In addition, it has been found that investors adjust their positions if they believe there are undisclosed derivatives losses (Sapra and Shin, 2004).

Other studies have found media visibility to be important to levels of disclosure (Cormier and Magnan, 1999, 2003; Leventis and Weetman, 2004). It is possible that visibility might be associated with the quantity of information, in that a company who discloses greater volume (without quality) might attract investors. Equally, it is expected that a company with high quality disclosure should be followed more.

Prior studies have found that the more informative disclosure practices become, then correspondingly the more analysts followed the company, and the more accurate these analysts’ earnings forecasts became (Lang and Lundholm, 1996; Barth, 170 Although this is caveated by Bushee and Noe’s (2000) findings about more and less desirable investors extra disclosure might attract.
Landsman and Lang, 2008). Therefore, this investigation examines expected relationships between visibility and quantity and quality.

6.3.2.1.1 Marketability

It is thought that increased and more frequent trading of a company’s shares indicates greater understanding of a company’s position and performance. One would expect that with greater volume and increased quality of information being processed by the market participants, there would be a correspondingly higher trading level.

Consistent with theoretical arguments from prior studies (Scott, 1994; Cormier and Magnan, 1999 and 2003; Leventis and Weetman, 2004) it is held that increased trade in the volume of a company’s shares shows greater information being processed by the market participants. One would expect that both quantity and quality of information would impact on trading volumes; however, they might impact differently and might not be of equal worth to investors. In other words, a company that discloses more (in quantity terms) provides more information for investors to trade on. However, it is worth noting this will not always be costless if there is an obfuscation or legitimisation strategy in action. Equally, those that provide higher levels of quality will lessen information costs by providing information that investors require to make better decisions.

There is, of course, the problem that the disclosure strategy employed in the annual report cannot be extrapolated and taken as a representation of a firm’s disclosure strategies throughout the rest of the year.¹⁷¹ However, the annual report disclosure strategy is most likely an indicator of disclosure strategies employed by the company. Therefore the following relationships are predicted:

\[ H1a\&b. \text{ It is expected that greater marketability will be positively related to greater quantity (H1a) and increased quality (H1b) of financial instruments disclosures.} \]

¹⁷¹ Nor is it possible for a weighting against the credibility of the information flow although the annual report is the most credible information source.
6.3.2.1.2 Volatility

Greater volatility is associated with increased levels of information being processed by the investors, who either invest or disinvest given the predicted direction of the news. Additional quantity or quality of disclosure not only encourages trading volume but also serves to reduce the information costs for investors. Prior studies have found there is a relationship between volatility and disclosure levels; however, the direction has been found to be both positive and negative (Leventis and Weetman, 2004; Cormier and Magnan, 2003). This is probably due to interpretation and information credibility issues. Therefore, on the basis of theoretical arguments and empirical studies, the direction of the relationship between quantity, quality and volatility cannot be predicted and the following hypotheses are tested:

\[ \text{H2a\&b. Higher levels of volatility are expected to be related to the quantity (H2a) and quality (H2b) of financial instruments disclosure.} \]

6.3.2.1.3 Dividends

A higher level of disclosure is often associated with a will to close the asymmetry gap and to avoid costs, such as those associated with litigation (Watts and Zimmerman, 1978; Francis, 2004), to minimise risk and to minimise information costs. Therefore, companies with lower levels of disclosure in both quantity and quality are expected to pay higher dividends to compensate investors for the increased risk of investment. Therefore, this study predicts that there is a negative association between both quantity and quality and dividends:

\[ \text{H3a\&b. Higher dividends per share is expected to be negatively related to the quantity (H3a) and quality (H3b) of financial instruments disclosure.} \]

6.3.2.1.4 Managerial ownership

The greater the level of managerial ownership, then it is expected that there is a respective dampening of the problems associated with information asymmetry. Agency costs and information costs become increasingly less important as the
managerial stake gets larger. Prior research has found that the higher the level of external equity ownership, the greater the levels of disclosure (Ashbaugh, 2001; Dumontier and Raffournier, 1998). Therefore, one would expect a negative direction between managerial ownership and disclosure quantity and quality:

**H4a&b.** Companies with greater levels of managerial ownership are expected to provide a lower quantity (H4a) and quality (H4b) of financial instruments disclosures than those with greater levels of external ownership.

6.3.2.1.5 Interest cover

As with the hypothesis above that shareholders are compensated for additional risk via dividends, and require less information where the risk is lower, equally one would expect a similar relationship for interest cover. Where interest cover decreases, one would expect to see higher levels of disclosure either to legitimise or obfuscate this signal.

**H5a&b.** Companies with higher levels of interest cover are expected to provide a lower quantity (H5a) and quality (H5b) of financial instruments disclosures than those with higher levels.

6.3.2.1.6 News/analyst following

External visibility can be seen as a product of two components. The first component relates to the number of analysts following a company. As noted above, prior research has indicated that a firm that adopts an informative disclosure policy and practice encourages an increased number of analysts following the company. This, in turn, generates the positive result of more accurate analyst earnings forecasts (Lang and Lundholm, 1996). However, the second component necessary to understand the level of external visibility is to gauge the intensity of this following. This is achieved by measuring the number of press releases issued about the company concerned. This is often seen in social disclosure studies. When combined, these two items are then measured against each other, i.e. the number of press releases divided by the number of analysts following the company.
One advantage of this approach to measuring visibility is that there is also the possibility that this will control for abnormal events during the period, as more analysts might follow a company for a short time when an unusual event occurs – but correspondingly more press releases will be issued, which will erase some of this bias. In the past, studies have chosen to measure visibility simply as the number of press releases (for example, Neu et al., 1998). However, the measurement for visibility employed in this study is more accurate and is an adaptation of a measure adopted by a small number of prior disclosure studies (Cormier and Magnan, 2003; Leventis and Weetman, 2004).

Both Cormier and Magnan and Leventis and Weetman found that visibility was positively associated with disclosure practices. The former, however, looked at this variable in an environmental disclosure context and drew data from French companies, whilst the latter found an association between visibility and dual language reporting in Greece. In both cases, intuition tells one that increases in media visibility determines levels of disclosure. In contrast, companies considered by this study are much larger than those considered where this positive relationship has been found. The non-financial FTSE 100 companies commonly have high levels of visibility and relatively large numbers of analysts following. Therefore, the disclosures in the annual report might be less news-worthy and, given the nature, complexity and scope of financial instruments disclosures themselves, the direction of the relationship is not as easy to predict.

There is a further factor here in that one would expect that higher levels of disclosure quality would serve to increase analyst following on the basis that it is informative (at least in principle) and would raise the number of press releases. However, an increase in the quantity of disclosures does not necessitate an increase in informativeness and thus, in theory, should not equate to more press releases and analysts following.

On balance, one would expect that greater visibility will lead to higher levels of disclosure as demands for more and higher quality information increase correspondingly. Therefore the following relationships are predicted:
H6a&b. Companies with higher visibility are expected to provide more (H6a) and higher quality (H6b) financial instruments disclosures.

6.3.2.1.7 Industry: Oil & gas and mining

Despite full financial instruments disclosures being proprietary, in nature the willingness to disclose has been found to be related to industry (Chalmers and Godfrey, 2004; Lopes and Rodrigues, 2007). Those companies classified as oil and gas or mining are more likely to disclose greater levels of information due to a combination of: the heavy reliance on derivative financial instruments in the management of their business; the pressure from externalities for additional information (Dye, 1990); the willingness to facilitate pricing and production related decisions (Rajgopal, 1999; Kanodia et al., 2000); and to either legitimise derivatives usage, position and performance or to create the impression that the derivatives trading patterns conform to the rest of the industry (and thus are associated with either signalling or agency costs respectively).

These theoretical underpinnings suggest that there will be a positive association between disclosure quantity and industry, but the direction of the relationship related to quality cannot be clearly defined. Therefore, the hypotheses below indicate a predicted positive direction in relation to industry classification:

H7a&b. Companies classified as operating in the oil and gas sector are expected to provide a greater quantity (H7a) and quality (H7b) of financial instruments disclosures.

H8a&b. Companies classified as operating in the mining sector are expected to provide a greater quantity (H8a) and quality (H8b) of financial instruments disclosures.

6.3.2.1.8 New share issue

Companies who are reliant on equity markets for financing will have greater incentives to minimise risks associated with information asymmetry (Frankel et al.,
1995; Cormier and Magnan, 1999). Lang and Lundholm (1993) have shown that analysts' ratings of firms' disclosure policies were higher for firms issuing equity. This result has been shown to be consistent in the case of debt issues also (Healy, et al., 1999). In addition, it has been shown that 6 months prior to an equity offer firms dramatically increase their disclosure activities (Lang and Lundholm, 2000). Therefore the following relationships are predicted:

_H9a. A share issue is expected to prompt increased quantity (H9a) and quality (H9b) of financial instruments disclosures._

6.3.2.2 Structure-related and performance-related variables

Contingency theory and quality-signalling have been investigated by looking to the position, performance and corporate governance of a firm (Toms, 2002; Hasseldine et al., 2005; Lopes and Rodrigues, 2007). Structure-related variables are expected to remain stable over time, whereas performance-related variables differ insomuch as they reflect shorter-term measures which are likely to impact on disclosures made within a specific reporting period (Lang and Lundholm, 1993).

6.3.2.2.1 Size

It has been found that companies that are larger are more likely to use financial instruments (Berkman and Bradbury, 1996; Berkman, Bradbury, Hancock and Innes, 2002). In addition, prior studies have found a positive relationship between company size and financial instruments disclosure quality and quantity (for example Chalmers and Godfrey, 2004; Hassan et al., 2008; Lopes and Rodrigues, 2007). Apart from the fact that the information is less costly to gather, collate and present for larger companies (Singhvi and Desai, 1971), the costs associated with non-disclosure or partial disclosure are potentially greater for firms with a strong external following (Dye, 1990). In addition, the associated competitive disadvantage sometimes associated with full disclosure reduces as a company becomes larger in size (Verrecchia, 1983). However, there are also benefits associated with adoption of a full and high quality disclosure practice. Amongst these underlying reasons are that high quality disclosure practices contribute towards user confidence (Watts and
Zimmerman, 1990) and thus reduce political costs and the associated risk attached to these.

H10a&b. Larger companies are expected to provide a greater quantity (H10a) and quality (H10b) of financial instruments disclosures than smaller companies.

6.3.2.2.2 Leverage

As borrowing levels increase then one would expect the importance of full disclosure to heighten, to ensure both debt holders and shareholders are satisfied with both the financial risks faced and the manner in which the risks are being managed. Despite this intuitive assessment, prior studies have found mixed results regarding the association between leverage and disclosure (Tower et al., 1999; Dumontier and Raffournier, 1998; Abd-Elsalam and Weetman, 2003; Chalmers and Godfrey, 2004).

H11a&b. Companies with higher leverage are expected to provide a greater quantity (H11a) and quality (H11b) of financial instruments disclosures.

6.3.2.2.3 Market capitalisation

The arguments are similar to those for size; however, Book to Market values differ to measures of size based upon assets. The greater the exposure to, and reliance on, capital markets, the greater the emphasis placed upon high quality disclosure (Verrecchia, 1983; Watts and Zimmerman, 1990). Therefore, the following hypotheses are derived:

H12a&b. Higher levels of market capitalisation are expected to be positively associated with the quantity (H12a) and quality (H12b) of financial instruments disclosures.

6.3.2.2.4 Profitability

Though prior disclosure studies have found little or mixed evidence of a significant relationship between profitability and adoption of new disclosures or levels of
disclosure (Abd-Elsalam and Weetman, 2003; Tower et al., 1999; Street and Gray, 2001; Street and Bryant, 2000; Dumontier and Raffournier, 1998), the impact of financial instruments on profitability specifically can often be material and significant. Whether a firm discloses more or less information and to a higher or lower quality when a firm is profitable or unprofitable, is difficult to predict; therefore the following hypotheses are tested:

**H13a&b. It is expected that there will be a relationship between higher levels of profitability and the quantity (H13a) and quality (H13b) of financial instruments disclosures.**

6.3.2.2.5 Liquidity

Due to the importance of financial instruments on current assets and current liabilities (not only because of their nature but also because of their size) and the pressure on companies to manage their working capital positions as effectively and efficiently as possible, it is expected that those firms with greater pressure on their liquidity position will disclose more, and the disclosure will be of a higher quality to reduce information costs.

**H14a&b. Companies who exhibit higher levels of liquidity are expected to disclose lower levels in terms of quantity (H14a) and quality (H14b) related to their financial instruments.**

6.3.2.2.6 Voluntary disclosures of financial instruments

Building upon the findings in chapter 5 related to material voluntary disclosures, it is expected that entities who disclose information over and above the mandated information requirements within IFRS 7 will produce both greater volume and quality disclosure.

**H15a & b. Companies who voluntarily disclose more information than the mandatory requirements of IFRS 7 are expected to disclose higher levels in terms of quantity (H15a) and quality (H15b) related to their financial instruments.**
6.3.2.2.7 Value of derivative assets / liabilities

It is expected that the value of the derivative financial instruments held will be associated with both the volume and quality of the information produced given the increased importance of the information in materiality terms to the user.

H16a & b. Companies with higher derivatives assets are expected to disclose greater levels in terms of quantity (H16a) and quality (H17b) related to their financial instruments.
H17a & b. Companies with higher derivatives liabilities are expected to disclose greater levels in terms of quantity (H17a) and quality (H17b) related to their financial instruments.
### Table 15: Explanatory variables and measurement

<table>
<thead>
<tr>
<th>Variables</th>
<th>Information source</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketability (MKT)</td>
<td>DataStream</td>
<td>Number of shares traded within the year / Number of shares in issue at beginning of the year</td>
</tr>
<tr>
<td>Volatility (VOL)</td>
<td>DataStream</td>
<td>This measures the degree of fluctuation in the share price during the previous 12 months, based on the last 52 weekly values. Volatility is calculated on a standard deviation of the price, and is a measure of its dispersion around the 12 month average. This standard deviation is then divided by the mean price, and the result is multiplied by 40 to give a figure in the scale from 1 to 20. This corresponds to a standard deviation range of 0 – 50%, so a volatility rating of 10 indicates a standard deviation of 25%. The higher the value, the higher the volatility of the stock.</td>
</tr>
<tr>
<td>Dividends per share (DIVSH)</td>
<td>DataStream</td>
<td>Dividend per ordinary share</td>
</tr>
<tr>
<td>Managerial ownership</td>
<td>Thomson One Banker</td>
<td>Percentage of current common shares outstanding owned by management / total current common shares outstanding</td>
</tr>
<tr>
<td>Interest cover (INTCOV)</td>
<td>DataStream</td>
<td>This is defined as Earnings Before Interest and Tax / Interest Expense on Debt less Interest Capitalised</td>
</tr>
<tr>
<td>Visibility</td>
<td></td>
<td></td>
</tr>
<tr>
<td>News / analyst following (NEWSANALYST)</td>
<td>Lexis/Nexis [news] / Thomson One Banker [analyst following]</td>
<td>Reported news items / number of analysts following</td>
</tr>
<tr>
<td>Industry (O&amp;G / MINING)</td>
<td>Thomson One Banker</td>
<td>Firm is engaged in oil &amp; gas or mining activities (1=yes; 0 = no)</td>
</tr>
<tr>
<td>New Share Issue (SHISSUE)</td>
<td>Annual report</td>
<td>Share issue during the year (1 = yes; 0 = no)</td>
</tr>
<tr>
<td>Structure-related variables</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size (SIZE)</td>
<td>Annual report</td>
<td>Natural log of total assets</td>
</tr>
<tr>
<td>Leverage (LEV)</td>
<td>DataStream</td>
<td>(Long Term Debt + Short Term Debt &amp; Current Portion of Long Term Debt) / Common Equity * 100</td>
</tr>
<tr>
<td>Market capitalisation</td>
<td>DataStream</td>
<td>Market Price-Year End * Common Shares Outstanding</td>
</tr>
<tr>
<td>Performance-related variables</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profitability (PROF)</td>
<td>DataStream</td>
<td>Net income / total assets</td>
</tr>
<tr>
<td>Liquidity (LIQ)</td>
<td>DataStream</td>
<td>Current ratio (current assets / current liabilities)</td>
</tr>
<tr>
<td>Derivative asset/liabilities (DERASS / DERLIAB)</td>
<td>Annual report</td>
<td>Natural log of balance sheet value of derivative assets / liabilities</td>
</tr>
<tr>
<td>Voluntary disclosure (VOL)</td>
<td>Annual report</td>
<td>Firm voluntarily produces information in excess of IFRS 7 requirements (1= yes ; 0=no) [see chapter 5]</td>
</tr>
</tbody>
</table>
6.4 Results: Stakeholder analysis of ED 7 (subsequently IFRS 7)

Many issues were raised by the comment letter writers alongside the specific outcome-oriented comments. Theoretical considerations were raised frequently and these were often underpinned by related queries about the usefulness of the information preparers were being asked to produce. One should note that respondents indicated that ED 7 was a significant step forward, both from IAS 30 and IAS 32. Following standard comment letter classification procedures (Yen et al., 2007; Weetman et al., 1996), letters were classified according to their overall position and detailed comments were subsequently analysed. Of particular concern to this study are the theoretical concerns raised, and these have been grouped under the qualitative characteristics headings, noting specifically if they were positive or negative. Tables 12a and 12b summarise these findings.

The overall attitudes towards ED 7 were positive, with 70 respondents indicating they were in general agreement with the ED becoming a full IFRS. These results are consistent with other studies of this type (Yen et al., 2007; Weetman et al., 1996; McEnroe, 1993). However, this top level analysis is less rewarding, and it is the substantive comments which provide far more depth when attempting to understand the position of the respondents.

It would appear that, far from being overwhelmingly negative, the comment letters showed a mixed response to the qualitative characteristics. From this analysis there is strong evidence that suggests that ED 7 would further the over-arching objective of usefulness which underpins the qualitative characteristics. In terms of these qualitative characteristics: 45% of letters with comments related to relevance were positive; 52% stated that the disclosures would ensure greater fair representation; 63% thought IFRS 7 would lead to an improvement in comparability; 30% felt that understandability would be enhanced; and 7% thought verifiability would be improved.

---

172 Further analysis has been undertaken and the results are presented in Chapter 7.
173 For further discussions of the inherent weaknesses of studying comment letters see Georgiou, (2004; 2010).
As one would expect, there are certain proposals which were most criticised. Many of these issues were amended before the final draft of IFRS 7. The IASB have proposed the two fundamental qualitative characteristics are relevance and faithful representation and it is reassuring to see that these appear to be widely supported. Further analysis shows that these might be even more positively supported after the consultation process has ironed out the issues raised by the comment letter writers.

In terms of relevance, 225 negative comments were noted. Many letter writers felt strongly that the internal capital disclosure requirements were irrelevant (26%) and would lead to issues such as a lack of reliability and comparability. This disclosure was deleted before the final draft. Of these, 41% asked for more guidance to ensure the information produced was relevant rather than simply criticising the requirements as unnecessary. The guidance has been improved in later drafts and amendments of the Standard.

With regards to faithful representation 78% of comments categorised as being negative related to clarification issues. Many respondents believed that for requirements to allow faithful representation further explanation was required. In particular, concerns were expressed about the level of disclosure within the sensitivity analysis.174 Only 8% of comments classified as negative in relation to faithful representation expressed general concern that the final Standard would not enable entities to practice this characteristic and these comments came almost exclusively from the insurance sector.

One should note however that some of the issues raised by respondents remained unchanged in the final draft of IFRS 7, such as the assertion that this information is not (as) relevant for non-financial firms or SMEs (32 respondents raised this issue). The most contentious item of disclosure was the proposed sensitivity analysis. Though most letters acknowledged that a sensitivity analysis was a benefit in general terms, they argued strongly that the guidance in the Standard was not specific enough and would lead to a lack of relevance (6 respondents), needed

---

174 It might be worth noting that the sensitivity analysis requirements remain largely unchanged even through to the current Standard despite attracting so much negative attention from respondents in the comment letter process as well as my survey and interview analysis.
clarification or further guidance to facilitate comparability (22 respondents), or needed specific guidance over quantitative issues (12 respondents).

When the ex-post survey of the comment letter writers was undertaken regarding their perceptions of IFRS 7 in terms of the qualitative characteristics, the results were largely positive (see Table 16). In total 14 completed responses were received (13%) plus a further 6 replies (6%) which stated general non-participation in surveys. The qualitative disclosures were by and large positively welcomed with relevance (3.93), fair representation (3.64) and understandability (3.43) showing strong support; whilst comparability (3.00), verifiability (2.50) and timeliness (2.79) showed mixed support. In terms of quantitative information one can see that the disclosures clearly facilitate an improvement to relevance across the board. Aside from the sensitivity analysis (2.00), the same can be said about reliability, comparability and understandability also. However, echoing the qualitative position, timeliness is also not aided by IFRS 7 requirements. The comment letter writers might be generally in favour of the requirements but one interviewee (1 - an analyst) revealed his underlying belief that “the detailed knowledge that go into their [i.e. the accounting standards] setting is pretty low and I struggle to understand many who claim otherwise”.175

The analysts and internals saw considerably higher deviations to their responses, but the mean responses indicate general support for the disclosure requirements and their ability to facilitate improved decision-making. Of particular note was that this group echoed the comment letter responses in so much as they indicated the disclosures were both relevant and reliable. As one treasury director stated: “I think the sentiment of IFRS 7 of trying to get some view of liquidity or trying to get a view of credit risk, for instance, particularly in the last 18 months, two years, is a very, very important point. And I think that’s right, stuff like that in, so I think that’s the good side of it.” Another interviewee (11), a financial controller, stated about IFRS 7 disclosures: “I think it’s relevant, it sets the tone of how management, managers or directors manage the risk, yes, the business, the financial instruments and the interest rate risk and market risks. That’s sort of the boundaries as to how risk

175 This clearly runs contrary to the claims of the IASB who argue that they are constantly communicating and are both pro-active and reactive in addressing concerns and possible concerns from stakeholders. See section 7.1 which identifies sections of the IASC’s due process handbook which relate to this point.
averse or risk hungry the directors are then with that, and personally I think it’s a good disclosure to have." However, there were certain disclosures which were less well received or were believed to consider a lower degree of useful information such as some aspects of the hedging disclosures and the sensitivity analysis.

Comparability was criticised during interviews, but mainly because of two key problems. The first issue that was brought to the researcher’s attention was the weaknesses of the standard setters generally and their inability to manage the financial reporting system overall. The second issue (more context specific) reported was the lack of economic comparability between entities disclosures because of organisational or accounting choices, rather than necessarily the fault lying with the financial instruments disclosures specifically.

To illustrate the first of these points, the central theme of one interview with one analyst (interviewee 8) was the perceived failure of the IASB to properly manage the financial reporting system as a whole. He was far more outspoken than any other interviewee but nevertheless, his opinions were interesting and he suggested on more than one occasion that other analysts would have to wake up to these issues like he has done. He argued: “it’s not just one standard, it’s not, it’s the fundamental philosophical approach in the way the IASB goes about looking at things”; and elsewhere: “I mean, fundamentally they [i.e. the IASB] are demonstrating a lack of understanding of what the purpose of reports and accounts are.” Another interviewee (9) argued that it was unfair to point the finger of blame at the standard setters but rather at the complexity of the markets and the self-interest of stakeholders. She explained that the IASB have “rather over-complicated it, probably because they’re getting so much input from everybody going, oh, we’ve got this class of asset, we’ve got this, we’ve got that, what do we do with it?”
### Table 16a: Comment letters summary

<table>
<thead>
<tr>
<th>Theoretical arguments</th>
<th>No. of classified comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Comparability</strong></td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>67</td>
</tr>
<tr>
<td>Positive</td>
<td>113</td>
</tr>
<tr>
<td><strong>Fair representation (Reliable)</strong></td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>50</td>
</tr>
<tr>
<td>Positive</td>
<td>55</td>
</tr>
<tr>
<td><strong>Relevance</strong></td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>225</td>
</tr>
<tr>
<td>Positive</td>
<td>183</td>
</tr>
<tr>
<td><strong>Timeliness</strong></td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>10</td>
</tr>
<tr>
<td>Positive</td>
<td>9</td>
</tr>
<tr>
<td><strong>Understandability</strong></td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>171</td>
</tr>
<tr>
<td>Positive</td>
<td>75</td>
</tr>
<tr>
<td><strong>Verifiability</strong></td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>26</td>
</tr>
<tr>
<td>Positive</td>
<td>2</td>
</tr>
<tr>
<td><strong>Outcome oriented arguments</strong></td>
<td></td>
</tr>
<tr>
<td>Clarification required</td>
<td>177</td>
</tr>
<tr>
<td>Additional disclosures required</td>
<td>155</td>
</tr>
<tr>
<td>Clearer guidance required</td>
<td>232</td>
</tr>
<tr>
<td><strong>Other arguments</strong></td>
<td></td>
</tr>
<tr>
<td>Conflict with IFRS 4 arguments</td>
<td>92</td>
</tr>
<tr>
<td>Detracts from annual report credibility</td>
<td>11</td>
</tr>
<tr>
<td>Comments on SFAS omissions from ED 7</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>6</td>
</tr>
<tr>
<td>Neutral</td>
<td>1</td>
</tr>
<tr>
<td>Positive</td>
<td>58</td>
</tr>
<tr>
<td><strong>Immaterial/lack of usefulness</strong></td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>76</td>
</tr>
<tr>
<td>Neutral</td>
<td>1</td>
</tr>
<tr>
<td>Positive</td>
<td>38</td>
</tr>
<tr>
<td><strong>Location of disclosures</strong></td>
<td></td>
</tr>
<tr>
<td>Unaudited</td>
<td>53</td>
</tr>
<tr>
<td>Unaudited but cross referenced</td>
<td>3</td>
</tr>
<tr>
<td><strong>Implementation practicality issues and problems</strong></td>
<td>226</td>
</tr>
<tr>
<td>Requires greater flexibility</td>
<td>32</td>
</tr>
<tr>
<td><strong>Transparency</strong></td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>10</td>
</tr>
<tr>
<td>Positive</td>
<td>9</td>
</tr>
<tr>
<td><strong>Other comments</strong></td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>58</td>
</tr>
<tr>
<td>Positive</td>
<td></td>
</tr>
<tr>
<td>Total (All comment types)</td>
<td>2,343</td>
</tr>
</tbody>
</table>
Table 16b: Analysis of respondent attitudes towards adoption of ED 7

<table>
<thead>
<tr>
<th>Interest Group</th>
<th>Positive</th>
<th>Neutral</th>
<th>Negative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional bodies: Accounting</td>
<td>24</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Professional bodies: Banking</td>
<td>13</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Professional bodies: Insurance</td>
<td>6</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Professional bodies: Other</td>
<td>8</td>
<td>1</td>
<td>7</td>
</tr>
<tr>
<td>Preparers: Banks and financial institutions (excl insurance)</td>
<td>8</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Preparers: Insurance</td>
<td>5</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Preparers: Other</td>
<td>2</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Accounting firms</td>
<td>4</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Other – unaffiliated</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>70</strong></td>
<td><strong>8</strong></td>
<td><strong>28</strong></td>
</tr>
</tbody>
</table>

The second point noted above - organisational differences leading to a lack of comparability and a lack of usefulness - were frequently discussed and most commonly by analysts. To illustrate, one treasury director (interviewee 9) complained: “Comparability, I mean, we have certainly heard from analysts that there’s no comparability, that there’s in fact no comparability across industries (related to financial instruments disclosures).” It seems that the preparers are aware of these issues but have little sympathy. A financial controller (interviewee 11) remarked: “I don’t look at others [i.e. other companies]. Is it [i.e. the disclosures] comparable? I think with regards to basic structure, yes, but as regards to contents, no, because it is different from a management point of view, which is what tends to be what the IASB is pushing towards, it’s going to be different for each company. I mean if it was a medical devices company we produce medical devices, that’s going to be different to the likes of banking to retail, it’s going to be different to RBS and so forth, because there are different risks, different appetites. So it’s not going to be comparable, it’s got to have the same basic structure as, this is interest, this is the commodities, this is the market, this is the sensitivity to change, but how they’re ultimately being managed is going to be different. So no, it’s not going to be comparable from that point of view. And even within our own sector of industries, it’s not going to be really comparable; it really is different from a management’s point of view.” He thought that the lack of comparability was driven by the flexibility of principles-based accounting requirements. He argued that in some cases these improved the quality of disclosures but in some cases significantly impaired them noting especially the lack of guidance around the sensitivity analysis disclosures.
Interviewed analysts also made comments about this inherent lack of comparability. One analyst (interviewee 1), for example, who dealt with the engineering industry remarked: “the specifics of everything are different and therefore you need to look to slightly different markets to understand what’s going on. A good example... I mean two companies I follow [sic] in the UK which are in theory directly comparable, which are AMEC and Wood Group... the simple fact that one has a functional currency in sterling and the other one is dollars and the reporting currency is the same means that your ability... I mean... I simply do not have access to the information [sic].” An ex-accountant, now investor relations personnel (interviewee 2), defended the disclosures but agreed with the inherent lack of comparability stating: “I don’t necessarily think that if you were to compare two sets of accounts they would necessarily be comparable, because every company comes at risk from a different point of view, so I think that kind of thing, the disclosure is less helpful, but I do think it’s important”.

Though these concerns about comparability are important, they do not directly impinge on the quality of the financial instruments disclosures. The criticisms of comparability relate to general environmental and economic problems rather than the fault of the requirements. In fact, the requirements themselves were thought to have brought about more comparable information but with the caveat that perfect comparability was not achievable because of the nature of the subject. This argument was put a different way by one interviewee (11) who was a group financial controller. He stated: “I think IFRS 7 specifically was put into place because it said, please disclose in the accounts what you’re disclosing to the management board anyway. I think they just put in a bit more things that they wanted to see in the disclosure which might not necessarily have been presented to the board in the first place, which is what I’ve seen in the past, but I think in general that it’s comparable, what’s been given to the board is what is now being asked to be disclosed.”

Verifiability consistently scores around 3 (out of 5) showing neither agreement nor disagreement. The issue here is one of information asymmetry. The capacity to verify qualitative information will always be difficult. One analyst noted that “there’s no way for us to interrogate balances, we have to believe their maximum fair value is
correct because the people who are making that assessment are company management, submitted and agreed with the investment bank - which has a vested interest... and you’ve got the company management team who invariably don’t understand the instrument and the accountants who certainly don’t understand the instrument in terms of mechanics and risk profiles... that gets us nowhere”. However, another interviewee (11) made the following challenging remark to counteract this analyst’s (and other similar) claims. In response to whether there was deliberate manipulation or obfuscation of information he said: “If someone actually agrees with that, agrees or strongly disagrees, the question is, what are you saying about management? If you say management is dishonest, potentially fraudulent and then you can’t rely on anything they say, never mind the IFRS 7 disclosures, the whole damned thing becomes worthless, and obviously there’s going to be the odd black sheep here and there, but I think in general, management tries to be honest and forthcoming, well, you can’t disclose everything, because there is some sort of strategic value not to disclose everything for competitive reasons, but you kind of be as honest and forthcoming as you can be. And I think IFRS 7 and the IFRS in general try and promote that.”

Timeliness is an underlying problem for financial reporting in general given the historic nature of the information presented but this is particularly acute where fair value reporting is a key issue such as with financial instruments recognition and measurement. Arguably this puts more strain on the information content of the associated disclosures. As one comment letter writer stated during their interview: “I think [timeliness is a problem] because [the information is] not forward looking, just looking into the past, and of course I think Deutsche Bank… they publish their annual report I think in February,”176 so that is relatively quick but there are of course some other banks maybe which just publish in March or April… of course then the information is nearly irrelevant.” (Interviewee 5) Timeliness was picked up as a problem by interviewee 4 during a discussion of fair value. He argued that requirements associated with fair value and fair value related disclosures were further negatively impacting on the pre-existing timeliness problems. He said: “and therefore what does it create? – distortion, which delays your ability to process the

---

176 In connection with banks with 31 December year-ends.
results fully and with confidence. If you imagine trying to get a note out after the post results meeting, that would be a classic example, or if you’re doing your year end review on the stock or after an acquisition, whatever it is, it delays, so therefore it reduces the efficiency of the market in short, not that anybody could make money out of a perfect market, but the point is that if we’re heading to at least something that approaches an efficient market, if that’s what we’re supposed to be aiming for knowing it’s an unachievable goal, then of course it delays that progress and doesn’t add to efficiency in the market which is what it’s supposed to do, but essentially it’s supposed to help you price the assets more fairly and the lack of timeliness doesn’t help that.”

Although the response rate was reasonable (63 responses; 16.2%), a higher return rate from preparers and analysts would have been preferable to be able to robustly state that the responses collected were wholly representative of non-financial firms’ views of IFRS 7. The general impressions from analysts and internals who completed the survey and provided interviews were, broadly speaking, that they were reasonably satisfied with the majority of the requirements of the standard and the disclosure that was being produced. Most stated that the disclosure was a significant improvement on what had gone before and the addition of the ‘through the eyes of management’ principle was important. The majority opinion was that the mandated requirements would make the financial statements more relevant, more reliable, more comparable and more understandable. However, as stated previously, certain issues came under particular criticism.
Table 17: Survey summary\textsuperscript{177}

<table>
<thead>
<tr>
<th>Question</th>
<th>Comment letter writers responses (n=14)</th>
<th>Analysts and internals responses (n=63)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Max</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>------</td>
<td>-----</td>
</tr>
<tr>
<td>Question 1: Does IFRS 7's qualitative disclosure aid the fulfilment of the following fundamental characteristics:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relevance</td>
<td>3.93</td>
<td>5.00</td>
</tr>
<tr>
<td>Reliability</td>
<td>3.64</td>
<td>5.00</td>
</tr>
<tr>
<td>Comparability</td>
<td>3.00</td>
<td>4.00</td>
</tr>
<tr>
<td>Understandability</td>
<td>3.43</td>
<td>5.00</td>
</tr>
<tr>
<td>Verifiability</td>
<td>2.50</td>
<td>3.00</td>
</tr>
<tr>
<td>Timeliness</td>
<td>2.79</td>
<td>5.00</td>
</tr>
<tr>
<td>Question 2: Does IFRS 7's quantitative disclosures aid the fulfilment of the following fundamental characteristics:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Carrying value of financial instruments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relevance</td>
<td>4.46</td>
<td>5.00</td>
</tr>
<tr>
<td>Reliability</td>
<td>4.17</td>
<td>5.00</td>
</tr>
<tr>
<td>Comparability</td>
<td>4.25</td>
<td>5.00</td>
</tr>
<tr>
<td>Understandability</td>
<td>3.33</td>
<td>5.00</td>
</tr>
<tr>
<td>Verifiability</td>
<td>3.33</td>
<td>5.00</td>
</tr>
<tr>
<td>Timeliness</td>
<td>2.83</td>
<td>5.00</td>
</tr>
<tr>
<td>b) Fair value of financial instruments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relevance</td>
<td>3.75</td>
<td>5.00</td>
</tr>
<tr>
<td>Reliability</td>
<td>4.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Comparability</td>
<td>4.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Understandability</td>
<td>3.83</td>
<td>5.00</td>
</tr>
<tr>
<td>Verifiability</td>
<td>3.33</td>
<td>5.00</td>
</tr>
<tr>
<td>Timeliness</td>
<td>2.75</td>
<td>5.00</td>
</tr>
<tr>
<td>c) Hedging disclosures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relevance</td>
<td>3.75</td>
<td>5.00</td>
</tr>
<tr>
<td>Reliability</td>
<td>3.83</td>
<td>5.00</td>
</tr>
<tr>
<td>Comparability</td>
<td>3.50</td>
<td>5.00</td>
</tr>
<tr>
<td>Understandability</td>
<td>3.42</td>
<td>4.00</td>
</tr>
<tr>
<td>Verifiability</td>
<td>3.33</td>
<td>5.00</td>
</tr>
<tr>
<td>Timeliness</td>
<td>2.83</td>
<td>4.00</td>
</tr>
<tr>
<td>d) Sensitivity analysis</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relevance</td>
<td>3.42</td>
<td>5.00</td>
</tr>
<tr>
<td>Reliability</td>
<td>2.00</td>
<td>4.00</td>
</tr>
<tr>
<td>Comparability</td>
<td>2.83</td>
<td>4.00</td>
</tr>
<tr>
<td>Understandability</td>
<td>3.75</td>
<td>5.00</td>
</tr>
<tr>
<td>Verifiability</td>
<td>3.42</td>
<td>5.00</td>
</tr>
<tr>
<td>Timeliness</td>
<td>3.08</td>
<td>5.00</td>
</tr>
<tr>
<td>e) Other disclosures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relevance</td>
<td>3.80</td>
<td>5.00</td>
</tr>
<tr>
<td>Reliability</td>
<td>3.00</td>
<td>4.00</td>
</tr>
<tr>
<td>Comparability</td>
<td>3.00</td>
<td>4.00</td>
</tr>
<tr>
<td>Understandability</td>
<td>2.80</td>
<td>4.00</td>
</tr>
<tr>
<td>Verifiability</td>
<td>3.00</td>
<td>4.00</td>
</tr>
<tr>
<td>Timeliness</td>
<td>2.80</td>
<td>5.00</td>
</tr>
</tbody>
</table>

\textsuperscript{177} See Appendix H for the full survey instrument.
The sensitivity analysis attracted a great deal of negative attention and this is borne out by the survey responses, the comment letter feedback and the interviews. This is not to say that many respondents did not see merit in the disclosures as a way of facilitating the qualitative characteristics but the overall feeling towards these requirements was negative and this was made especially clear during the interviews. The timeliness and verifiability of this information were again criticised. This issue has been discussed in greater detail in section 4.4.7 and will not be reconsidered here.

Though many interviewees recorded positive statements about the mandated requirements of IFRS 7, they all had specific concerns which they thought needed to be addressed. Both analysts and preparers expressed concerns of a move away from a reliance on financial statements, and discussed their belief that there was a shift towards a ‘two-tiered’ reporting system where more detailed, more useful and more usable information is presented to analysts in the format they want it, i.e. not the annual report. Several of the interviewees felt that the notes to financial statements were under-utilised, partly due to information overload and partly due to broader professional issues such as demands on analysts’ time, a lack of technical abilities and skills and a serious deficiency in accounting knowledge.

It is also important to note that a small number of those interviewed held strong negative views about the IASB, the standard setting process, the purpose of financial statements, and in particular the notes to the financial statements. When one analyst was asked whether they felt the Standard could be improved, it was stated: “I think the problem is more fundamental than just tweaking standards that they’re issuing. The criteria by which they judge the new standards are wrong, they’re coming at it from completely the wrong approach... and it’s Tweedie... it’s the poison that he’s spread throughout his career and it’s just latched in.”

On balance, though the evidence clearly isn’t without criticism of the standard and the standard setting process, the results broadly support the notion that the Standard facilitates the overarching theme of information usefulness, which in turn is underpinned by the qualitative characteristics. There are significant doubts over certain aspects of IFRS 7, such as the required disclosure of a sensitivity analysis,
and especially with regards to inadequate guidance provided by the IASB in standardising and presenting this analysis. There are also concerns amongst interviewees about whether this information is utilised effectively and, in some cases, whether it is even considered by analysts. In addition there are problems identified which relate to a lack of timeliness, but, as stated by one interviewee (19), any gains in timeliness would be offset by losses in the other characteristics. In summary, it is believed that due process has been adhered to and that the findings from the comment letters review, surveys and interviews do not highlight or point towards significant concerns regarding the question of whether IFRS 7 captures the notion of ‘quality’.

6.5 Results: Determinants of financial instruments disclosures

6.5.1 Descriptive analysis

Table 18 reports mean financial instruments disclosures quantity and quality for first year adopting FTSE 100 non-financial companies, and Table 19 summarises the descriptive statistics for the independent variables. On average, companies’ disclosure quality appears high and these results indicate significantly higher levels of compliance than prior studies of a similar nature\(^\text{178}\) (see section 1.3 for a review of compliance literature and 1.3.2 for details of financial instruments disclosure compliance work). For financial years commencing on or after 1 January 2007, the quantity of disclosure attributed to financial instruments is high even for non-financial firms which are not heavily reliant on derivatives based risk management strategies. The results show that these firms’ disclosures of financial instruments averaged 3.9% of the words in the annual report as a whole, 4% of the pages and 8.9% of the lines of the annual report. The company with the least amount of words disclosed still devoted 1% to financial instruments disclosures whilst the company with the most gave over 8.2% to this area (for more details of levels of quantity see appendix G).

\[^{178}\text{Although, in my opinion, any non-compliance or failure to report non-compliance is unacceptable.}\]
Table 18: Dependent variable: Quantity and quality

<table>
<thead>
<tr>
<th></th>
<th>Min</th>
<th>Max</th>
<th>Mean</th>
<th>S.D.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quantity</td>
<td>0.010</td>
<td>0.082</td>
<td>0.039</td>
<td>0.018</td>
</tr>
<tr>
<td>Quality: Disclosure index*</td>
<td>0.691</td>
<td>1.000</td>
<td>0.942</td>
<td>0.057</td>
</tr>
</tbody>
</table>

* Quality: Categories within the disclosure index are as follows:

(1) BALANCE SHEET
- Categories of financial assets and financial liabilities: 0.667 1.000 0.992 0.048
- Financial assets or liabilities at fair value through profit or loss: 0.000 1.000 0.965 0.147
- Reclassification: 0.000 1.000 0.875 0.311
- Derecognition: 1.000 1.000 1.000 -
- Collateral: 0.600 1.000 0.985 0.074
- Allowance account for credit losses: 0.000 1.000 0.893 0.312
- Compound financial instruments with multiple embedded derivatives: 0.000 1.000 0.958 0.204
- Defaults and breaches: 0.000 1.000 0.667 0.577

(2) INCOME STATEMENT AND EQUITY
- Items of income, expense, gains or losses: 0.286 1.000 0.957 0.116

(3) OTHER DISCLOSURES
- Accounting policies: 0.143 1.000 0.864 0.180
- Hedge accounting: 0.571 1.000 0.955 0.091
- Fair value: 0.500 1.000 0.944 0.106

(4) NATURE AND EXTENT OF RISKS ARISING FROM FINANCIAL INSTRUMENTS
- Qualitative disclosures – credit risk: 0.200 1.000 0.952 0.141
- Quantitative disclosures – credit risk: 0.000 1.000 0.970 0.173
- Qualitative disclosures – liquidity risk: 0.200 1.000 0.942 0.139
- Quantitative disclosures – liquidity risk: 1.000 1.000 1.000 -
- Qualitative disclosures – market risk: 0.800 1.000 0.985 0.053
- Quantitative disclosures – market risk: 1.000 1.000 1.000 -
- Qualitative disclosures – other risks: 0.667 1.000 0.978 0.086
- Further credit risk disclosures: 0.250 1.000 0.915 0.181
- Further liquidity risk disclosures: 0.750 1.000 0.976 0.060
- Further market risk disclosures – sensitivity analysis: 0.000 1.000 0.785 0.290

(5) ADOPTION AND EXEMPTIONS
- Early adoption: 0.000 1.000 0.045 0.210
- Exemption from preparing comparative information: N/A N/A N/A N/A
Table 19: Descriptive statistics for independent variables

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Min</th>
<th>Max</th>
<th>Mean</th>
<th>Std Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>MKT</td>
<td>0.03</td>
<td>8.13</td>
<td>2.10</td>
<td>1.19</td>
</tr>
<tr>
<td>VOL</td>
<td>3.00</td>
<td>20.00</td>
<td>7.21</td>
<td>3.84</td>
</tr>
<tr>
<td>DIVSH (pence)</td>
<td>0.00</td>
<td>84.89</td>
<td>21.84</td>
<td>20.66</td>
</tr>
<tr>
<td>MANOWN (%)</td>
<td>0.00</td>
<td>0.59</td>
<td>0.04</td>
<td>0.12</td>
</tr>
<tr>
<td>INTCOV (no. of times)</td>
<td>(3.19)</td>
<td>214.83</td>
<td>19.15</td>
<td>38.32</td>
</tr>
<tr>
<td>NEWSANALYST</td>
<td>1.45</td>
<td>22.91</td>
<td>7.51</td>
<td>4.20</td>
</tr>
<tr>
<td>O&amp;G (1/0)</td>
<td>0.00</td>
<td>1.00</td>
<td>0.11</td>
<td>0.32</td>
</tr>
<tr>
<td>MIN (1/0)</td>
<td>0.00</td>
<td>1.00</td>
<td>0.08</td>
<td>0.27</td>
</tr>
<tr>
<td>SHISSUE (1/0)</td>
<td>0.00</td>
<td>1.00</td>
<td>0.23</td>
<td>0.42</td>
</tr>
<tr>
<td>SIZE (log of total assets)</td>
<td>7.08</td>
<td>11.82</td>
<td>9.01</td>
<td>1.14</td>
</tr>
<tr>
<td>LEV (%)</td>
<td>(6.82)</td>
<td>17.90</td>
<td>0.92</td>
<td>2.52</td>
</tr>
<tr>
<td>MKTCAP (log of mkt cap)</td>
<td>14.62</td>
<td>18.57</td>
<td>15.92</td>
<td>1.09</td>
</tr>
<tr>
<td>PROF (%)</td>
<td>(0.10)</td>
<td>0.80</td>
<td>0.13</td>
<td>0.14</td>
</tr>
<tr>
<td>LIQ (CA:CL)</td>
<td>0.20</td>
<td>7.94</td>
<td>1.29</td>
<td>1.23</td>
</tr>
<tr>
<td>VOLUNTARY(1/0)</td>
<td>0.00</td>
<td>1.00</td>
<td>0.15</td>
<td>0.36</td>
</tr>
<tr>
<td>DERASS (log of derivative assets)</td>
<td>0.00</td>
<td>9.90</td>
<td>3.90</td>
<td>2.58</td>
</tr>
<tr>
<td>DERLIA (log of derivative liabilities)</td>
<td>0.00</td>
<td>9.93</td>
<td>3.86</td>
<td>2.44</td>
</tr>
</tbody>
</table>

Table 21 shows Pearson cross-correlations between the variables. As expected, quantity and quality are positively associated; however, one would have expected to see a greater significance to this relationship. Prior studies have consistently found relationships between the level of disclosure and size in addition to the level of disclosure and industry classification. Though there is a positive relationship between quality of disclosure and size (0.14), there is a negative relationship between the quantity of disclosure and size (-0.16). Disclosure seems to be unrelated to both quantity and quality for mining companies; however, there is a negative correlation between quantity and oil and gas companies (-0.20) and a strong negative relationship with quality (-0.34).

Other positive relationships that exist between quality (QUAL) and the independent variables include: dividends per share (0.11); News/analyst following (0.17); market capitalisation (0.15); value of derivative assets (0.27); and value of derivative liabilities (0.10). Negative relationships exist between quality and marketability (-0.14), volatility (-0.21), levels of managerial ownership (-0.19), interest cover (-0.10), and share issue during the period (-0.24).
There are no significantly strong positive relationships that exist between quantity (QUAN) of disclosure and the independent variables. Predominantly, the relationships are negative, such as: levels of managerial ownership (-0.10); interest cover (-0.13); news/analyst following (-0.35); new share issue (-0.21); market capitalisation (-0.24); and derivative assets (-0.13).

There are also a number of relationships between the independent variables, which are interesting. Marketability is negatively associated with size (-0.32), market capitalisation (-0.41), derivative assets (-0.23) and derivative liabilities (-0.29), but positively with volatility (0.29). Volatility is positively related to managerial ownership (0.56), interest cover (0.18), mining (0.50) and liquidity (0.41) but negatively related to market capitalisation (-0.24), derivative assets (-0.28) and derivative liabilities (-0.25). As one might expect, dividends are positively associated with size (0.31) and negatively associated with managerial ownership (-0.22). Managerial ownership is positively associated with liquidity (0.32) but negatively associated with derivative assets (-0.23) and liabilities (-0.24), whilst interest cover has strong relationships with a company classified in the oil and gas sector (0.43) and liquidity (0.67). As one would expect, News/Analyst following is associated with size (0.35) and market capitalisation (0.48), but also profitability (0.26) and liquidity (-0.25). As expected, size and market capitalisation are strongly related (0.81). Voluntary reporting is positively associated with several variables including marketability (0.18), news/analyst following (0.23), being an oil and gas entity (0.14), size (0.11), market capitalisation (0.17) and the level of profitability (0.37). Finally the value of derivative assets is strongly positively related to market capitalisation (0.64) and the occurrence of a new share issue during the period (0.64). The level of derivative liabilities is also strongly positively associated with these variables – market capitalisation (0.61) and new share issue during the period (0.64). In addition the level of derivative assets is strongly correlated to the level of liabilities (0.72). Relatively strong negative relationships exist between the value of derivatives (assets and liabilities) and marketability (-0.23 [assets]; -0.29 [liabilities]), volatility (-0.28 [assets]; -0.20 [liabilities]), managerial ownership (-0.23 [assets]; -0.24 [liabilities]) and liquidity (-0.18 [assets]; -0.31 [liabilities]).
To facilitate a better understanding of these relationships, regression analysis was undertaken. Initially tests were performed to identify univariate relationships, using simple OLS regressions. These results are presented in Table 20. Following this, multiple regression analysis was performed and these results are shown in Table 22.

6.5.2 Simple OLS regression results

It was found that News/Analyst following (H6a), a new share issue (H9a) and market capitalisation (H12a) proved to be statistically significant in relation to quantity. In relation to quality, managerial ownership (H4b), News/Analyst following (H6b), being classified as an oil and gas entity (H8b), new share issue (H9b) and the value of derivative assets (H16b), proved to be statistically significant. However, two major issues immediately leap out when reviewing these regression results: firstly, the number of variables that move against their predicted direction; and secondly, the directional relationship of the independent variables to the dependent variables.

As predicted, where there is a higher level of managerial ownership, the quality of the information produced significantly reduces. On the other hand, contrary to the outlined expectations, a negative relationship between News/Analyst following and quantity was also found, which signifies that the higher the media visibility becomes, then companies produce significantly less information. It should be noted, however,

---

179 Though this is an extensive list of independent variables it is worth noting that I also analysed the data using many other variables to identify the determinants of disclosure. The analysis consisted of three major sub-groups: accounting numbers; repetition of key words; and auditor. The first set of further independent variables tested sought to identify whether the accounting numbers drive disclosure quantity and/or quality. Amongst these were: i. Derivative assets (both current year and prior year); ii. Derivative liabilities (both current year and prior year); iii. Cash flow hedge gains (losses) (both current year and prior year); iv. fair value hedge gains (losses) (both current year and prior year); v. Realised gains (losses) (both current year and prior year) related to financial instruments classified as fair value through profit or loss; vi. Realised gains (losses) (both current year and prior year) related to financial instruments classified as available for sale; vii. Long-term borrowings (both current year and prior year). The second major set of further independent variables sought to identify whether the rhetorical device – repetition of key words – drive disclosure quantity and/or quality. Amongst these were repetitions of the words: i. Hedg-e (and derivations thereof); ii. Speculat-e (and derivations thereof); iii. Breach; iv. Default; v. Derivative. The third and final group analysed the data to see whether the auditor was a significant determinant of quantity and/or quality. Several variables were found to be significant at the 10% level but none at 5% or 1%. Those which were found to be significant at the 10% level were: quantity and derivative assets (prior year) (negative association); quality and derivative liabilities (current year) (positive association); quality and having Deloitte as an auditor (negative association); quality and having PwC as an auditor (positive association).
that where media visibility is higher, then the information quality tends to increase, and in the case of News/Analyst following this relationship is significant.

Table 20 OLS simple regression\textsuperscript{180}

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Variable</th>
<th>Pred. Direction</th>
<th>QUAN Coefficient</th>
<th>T-stat</th>
<th>QUAL Coefficient</th>
<th>T-stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information costs variables</td>
<td>MKT</td>
<td>+</td>
<td>-0.0004</td>
<td>-0.2265</td>
<td>-0.0068</td>
<td>-1.1089</td>
</tr>
<tr>
<td>VOL</td>
<td>0</td>
<td>-0.0004</td>
<td>-0.6075</td>
<td>-0.0031</td>
<td>-1.6437</td>
<td></td>
</tr>
<tr>
<td>DIVSH</td>
<td>-</td>
<td>0.000</td>
<td>0.3728</td>
<td>0.0003</td>
<td>0.8966</td>
<td></td>
</tr>
<tr>
<td>MANOWN</td>
<td>-</td>
<td>-0.0155</td>
<td>-0.7902</td>
<td>-0.0925</td>
<td>-1.4708</td>
<td>*</td>
</tr>
<tr>
<td>INTOV</td>
<td>-</td>
<td>-0.0001</td>
<td>-1.0382</td>
<td>-0.0002</td>
<td>-0.7817</td>
<td></td>
</tr>
<tr>
<td>Visibility variables</td>
<td>NEWSANALYST</td>
<td>+</td>
<td>-0.0015</td>
<td>-2.9007</td>
<td>+++</td>
<td>0.0024</td>
</tr>
<tr>
<td>O&amp;G</td>
<td>+</td>
<td>-0.0109</td>
<td>-1.5513</td>
<td>-0.0608</td>
<td>-2.7725</td>
<td>+++</td>
</tr>
<tr>
<td>MINING</td>
<td>+</td>
<td>-0.002</td>
<td>-0.2397</td>
<td>0.0095</td>
<td>0.3527</td>
<td></td>
</tr>
<tr>
<td>SHISSUE</td>
<td>+</td>
<td>-0.009</td>
<td>-1.7016</td>
<td>+</td>
<td>-0.0325</td>
<td>-1.8983</td>
</tr>
<tr>
<td>Structure related variables</td>
<td>SIZE</td>
<td>+</td>
<td>-0.0025</td>
<td>-1.2607</td>
<td>0.007</td>
<td>1.0853</td>
</tr>
<tr>
<td>LEV</td>
<td>+</td>
<td>0.0002</td>
<td>0.231</td>
<td>-0.0008</td>
<td>-0.269</td>
<td></td>
</tr>
<tr>
<td>MKTCAP</td>
<td>+</td>
<td>0.000</td>
<td>-1.92</td>
<td>+</td>
<td>0.000</td>
<td>0.883</td>
</tr>
<tr>
<td>Performance related variables</td>
<td>PROF</td>
<td>0</td>
<td>0.0034</td>
<td>0.1999</td>
<td>0.0027</td>
<td>0.0495</td>
</tr>
<tr>
<td>LIQ</td>
<td>-</td>
<td>0.001</td>
<td>0.5329</td>
<td>-0.002</td>
<td>-0.3338</td>
<td></td>
</tr>
<tr>
<td>VOL</td>
<td>+</td>
<td>-0.0031</td>
<td>-0.4894</td>
<td>-0.0111</td>
<td>-0.5326</td>
<td></td>
</tr>
<tr>
<td>DERASS</td>
<td>+</td>
<td>-0.0009</td>
<td>-1.0212</td>
<td>0.0061</td>
<td>2.2091</td>
<td>**</td>
</tr>
<tr>
<td>DERLIAB</td>
<td>+</td>
<td>0.0003</td>
<td>0.2737</td>
<td>0.0024</td>
<td>0.7885</td>
<td></td>
</tr>
</tbody>
</table>

\textsuperscript{180} Tests were run to control for anomaly and outlier effects. When the regression analysis was re-run, controlling for these issues the results remained materially the same.

Oil and gas companies, despite their visibility, are producing significantly lower quality information, and what appears from the direction of the result, to also be less. It was predicted that a new share issue would lead to more, higher quality disclosure; however, it was found that in fact it leads to significantly less, lower quality disclosure. It was also observed that an increase in size – assets and market capitalisation – is associated with less information being produced – but of a higher quality.
Lopes and Rodrigues (2007) in a similar study, which focused on Portuguese listed entities, found associations with size, being audited by the Big Five and cross-listing. It is unsurprising that these results are not replicated in this study. There is, of course, the possibility of an association between the level of disclosure and size and cross listing; however, this sample includes much larger entities than those studied by Lopes and Rodrigues and this sample of firms have achieved a critical mass. In other words, they are all large and there is no point differentiating between large and huge, as it would make no difference. At this level, comparing one corporate behemoth to another and analysing size characteristics loses relevance to some degree. In addition, all are audited by the Big Four and all are listed on more than one exchange.

6.5.3 Multiple regression analysis

A number of the variables are highly related however the only independent variables that have a bivariate correlation greater than 0.70 (−0.70) are the value of derivative assets and the value of derivative liabilities and therefore no regression model employed uses both of these variables (Pearson, 2010; Gujarati, 2003). In order to overcome this problem the regression model was run for both measures of value i.e. derivative assets and derivative liabilities. The initial premise to the analysis and the model was that the analysis should include at least one variable from each of the four categories: information costs; visibility; structure-related; and performance-related.

One of the limitations of this analysis is the small number of observations measured against a relatively large number of independent variables (18) (Gujarati, 2003). Therefore, the model presented has rationalised these observations down to half that number. This high ratio of variables to observations weakens the results somewhat and future studies should consider extending the number of observations to add stability to the standard errors and beta weights. Certain variables were eliminated because they proxied for similar characteristics e.g. only one proxy was deemed to be required for size (total assets or market capitalisation). Other variables were eliminated because of high bivariate correlations and the impact on multicollinearity.
There are also potential problems associated with omitted variables and a brief discussion of this issue is included in the limitations section in chapter 8.

Frisch (1934) introduced the issue of multicollinearity which Gujarati (2003: 342) describes as follows: it “refers to the existence of more than one exact relationship, and collinearity refers to the existence of a single linear relationship. But this distinction is rarely maintained in practice, and multicollinearity refers to both.” One approach that is sometimes used to test the extent of multicollinearity is to calculate and analyse the variance inflation factor (VIF). This measure shows how the presence of multicollinearity inflates the variance of an estimator. The level of tolerance is the inverse of the VIF and these measures are used interchangeably (Pearson, 2010).

Conservative estimates have stated that if the VIF exceeds 5 then it is likely that multicollinearity will be a serious issue (Pearson, 2010; Gujarati, 2003). Others have suggested that this might be as high as 10 (Kutner, 2004), whilst O’Brien (2007) has argued that the VIF should be assessed according to context. O’Brien believed that the VIF might not be an indicator of serious issues even if it exceeded 40. The VIF calculations performed for this study indicate no issues with multicollinearity according to this measure as no factor exceeds 2.07.

Multiple regression analysis jointly tests the previously formulated hypotheses set out in section 6.3 and the results are provided in Table 22. Other models are not presented because they show no improvements on the final model presented: lower R²s were obtained alongside issues related to overall significance (F-stat).
Table 21: Pearson cross-correlations between variables

<table>
<thead>
<tr>
<th></th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
<th>18</th>
<th>19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quality</td>
<td>1</td>
<td>0.23</td>
<td>0.14</td>
<td>0.21</td>
<td>0.11</td>
<td>0.19</td>
<td>0.10</td>
<td>0.17</td>
<td>0.34</td>
<td>0.05</td>
<td>0.14</td>
<td>0.24</td>
<td>0.03</td>
<td>0.15</td>
<td>0.01</td>
<td>0.04</td>
<td>0.07</td>
<td>0.27</td>
</tr>
<tr>
<td>Quantity</td>
<td>2</td>
<td>(0.03)</td>
<td>(0.08)</td>
<td>0.05</td>
<td>(0.10)</td>
<td>(0.13)</td>
<td>(0.35)</td>
<td>(0.20)</td>
<td>(0.03)</td>
<td>(0.16)</td>
<td>(0.21)</td>
<td>0.03</td>
<td>0.22</td>
<td>0.03</td>
<td>0.07</td>
<td>0.06</td>
<td>0.13</td>
<td>0.04</td>
</tr>
<tr>
<td>Marketability</td>
<td>3</td>
<td>0.29</td>
<td>(0.14)</td>
<td>0.04</td>
<td>0.08</td>
<td>(0.03)</td>
<td>(0.04)</td>
<td>(0.01)</td>
<td>(0.32)</td>
<td>(0.11)</td>
<td>0.03</td>
<td>(0.41)</td>
<td>(0.09)</td>
<td>0.03</td>
<td>0.18</td>
<td>(0.23)</td>
<td>(0.29)</td>
<td></td>
</tr>
<tr>
<td>Volatility</td>
<td>4</td>
<td>(0.24)</td>
<td>0.56</td>
<td>0.18</td>
<td>(0.24)</td>
<td>(0.05)</td>
<td>0.50</td>
<td>(0.16)</td>
<td>0.04</td>
<td>(0.01)</td>
<td>(0.24)</td>
<td>0.05</td>
<td>0.41</td>
<td>0.10</td>
<td>(0.28)</td>
<td>(0.20)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividend per share</td>
<td>5</td>
<td>(0.22)</td>
<td>(0.11)</td>
<td>0.05</td>
<td>(0.09)</td>
<td>(0.11)</td>
<td>0.31</td>
<td>0.03</td>
<td>0.26</td>
<td>0.03</td>
<td>(0.18)</td>
<td>0.02</td>
<td>0.12</td>
<td>0.20</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managerial ownership</td>
<td>6</td>
<td>0.13</td>
<td>(0.19)</td>
<td>(0.02)</td>
<td>0.25</td>
<td>(0.17)</td>
<td>0.00</td>
<td>(0.05)</td>
<td>(0.17)</td>
<td>0.06</td>
<td>0.32</td>
<td>0.06</td>
<td>(0.23)</td>
<td>(0.24)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest cover</td>
<td>7</td>
<td>(0.20)</td>
<td>0.43</td>
<td>0.17</td>
<td>(0.18)</td>
<td>0.11</td>
<td>(0.14)</td>
<td>(0.02)</td>
<td>0.07</td>
<td>0.67</td>
<td>0.09</td>
<td>0.05</td>
<td>(0.24)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>News / analyst following</td>
<td>8</td>
<td>(0.16)</td>
<td>0.10</td>
<td>0.35</td>
<td>0.14</td>
<td>0.05</td>
<td>0.48</td>
<td>0.26</td>
<td>(0.25)</td>
<td>0.23</td>
<td>0.27</td>
<td>0.11</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>9</td>
<td>(0.11)</td>
<td>0.01</td>
<td>0.29</td>
<td>(0.09)</td>
<td>0.12</td>
<td>(0.06)</td>
<td>0.11</td>
<td>0.14</td>
<td>0.16</td>
<td>0.15</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mining</td>
<td>10</td>
<td>0.16</td>
<td>(0.02)</td>
<td>0.06</td>
<td>0.24</td>
<td>0.19</td>
<td>0.34</td>
<td>0.05</td>
<td>0.11</td>
<td>0.13</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New share issue</td>
<td>11</td>
<td>0.09</td>
<td>(0.04)</td>
<td>0.81</td>
<td>(0.08)</td>
<td>(0.28)</td>
<td>0.13</td>
<td>0.64</td>
<td>0.64</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size</td>
<td>12</td>
<td>(0.11)</td>
<td>0.10</td>
<td>0.13</td>
<td>0.02</td>
<td>0.11</td>
<td>(0.07)</td>
<td>0.04</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gearing</td>
<td>13</td>
<td>(0.08)</td>
<td>(0.11)</td>
<td>(0.12)</td>
<td>(0.03)</td>
<td>(0.10)</td>
<td>(0.10)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market Cap</td>
<td>14</td>
<td>0.10</td>
<td>(0.14)</td>
<td>0.17</td>
<td>0.64</td>
<td>0.61</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profitability</td>
<td>15</td>
<td>0.25</td>
<td>0.37</td>
<td>(0.13)</td>
<td>(0.11)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidity</td>
<td>16</td>
<td>0.10</td>
<td>(0.18)</td>
<td>(0.31)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Voluntary reporter</td>
<td>17</td>
<td>0.04</td>
<td>0.07</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Log derivative assets</td>
<td>18</td>
<td>0.72</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Log derivative liabilities</td>
<td>19</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The rank correlation between these two variables – quantity and quality – is higher at 0.328 but still not at the level where exclusion would be deemed necessary (Gujarati, 2003).
The key visibility variable – News/Analyst following – proved to be statistically significant in terms of both quantity (at the 1% level) and quality (at the 10% level when run as a two-tailed test). The results repeat the signal given by the simple regression results, that quantity decreases significantly the higher the level of visibility, but that quality significantly increases. When a company has issued shares during the year it can be seen that there is a negative association with the quality of disclosure. This result is somewhat surprising; however, one could argue that full risk analysis would be provided to potential investors in a prospectus leading up to the issue. Other results which are less surprising are the indication that companies with higher levels of managerial ownership appear to produce less disclosure in volume terms and companies with higher levels of derivative assets produce a higher quality of disclosure.

Table 22: Regression results

<table>
<thead>
<tr>
<th>Predicted direction</th>
<th>QUAN / QUAL</th>
<th>QUAN</th>
<th>QUAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Coefficients</td>
<td>t Stat</td>
<td>Coefficients</td>
</tr>
<tr>
<td>QUAN / QUAL</td>
<td>+</td>
<td>0.0873</td>
<td>2.1607 **</td>
</tr>
<tr>
<td>MKT</td>
<td>+</td>
<td>-0.0004</td>
<td>-0.2053</td>
</tr>
<tr>
<td>MANOWN</td>
<td>-</td>
<td>-0.0256</td>
<td>-1.3393 *</td>
</tr>
<tr>
<td>NEWSANALYST</td>
<td>-</td>
<td>-0.0018</td>
<td>-3.0666 ***</td>
</tr>
<tr>
<td>SHISSUE</td>
<td>+</td>
<td>-0.0049</td>
<td>-0.9111</td>
</tr>
<tr>
<td>SIZE</td>
<td>+</td>
<td>0.0004</td>
<td>0.1358</td>
</tr>
<tr>
<td>LEV</td>
<td>+</td>
<td>0.0003</td>
<td>0.3655</td>
</tr>
<tr>
<td>PROF</td>
<td>+</td>
<td>0.0176</td>
<td>0.9482</td>
</tr>
<tr>
<td>VOL</td>
<td>+</td>
<td>0.0018</td>
<td>0.2586</td>
</tr>
<tr>
<td>DERASS</td>
<td>+</td>
<td>-0.0010</td>
<td>-0.8542</td>
</tr>
</tbody>
</table>

Adj R²: 13.70% 10.21%

VIF calculations show no evidence of multicollinearity issues.

*** = significant at 1% level; ** = significant at 5% level; * = significant at 10% level
+++ = significant at 1% level if 2-tailed test; + = significant at 10% level if 2-tailed test
a = significant at 10% level if 1-tailed test with a predicted negative direction

182 These results have been tested for robustness (see Appendix G for further details) and no significant differences have been found between the measure of quantity as words and other suitable measures of quantity suggested by prior research.
6.5.4 Quantity as a proxy for quality: An extended analysis

Table 23 presents the results of the multiple regression analysis to highlight one specific point. The regression results are shown by direction to highlight the associations. In addition, the coefficients have been mapped into a chart to facilitate an easier reading of the results. It has been assumed that all tests are one-tailed and movements are in the predicted direction. They show that the relationship between certain independent variables and both dependent variables – quantity and quality – vary significantly.

One argument that appears both difficult and unpersuasive is that the quantity of disclosure should be lower for firms with higher visibility, and one which finds little support in prior research. Rather, one might expect firms with more visibility to have higher quality disclosures partly because they will have elevated information demands from externalities (Dye, 1990) – plus they most likely face greater litigation risk.

In the case of both structure-related and performance-related variables, it was found they all follow opposing directions in relation to quantity and quality. The directional interpretations suggest that the higher the levels of leverage, profitability and liquidity then the lower the volume of disclosure, but the higher the quality of these disclosures. The results also suggest that the larger the company, in terms of size and market capitalisation, the higher the quality of disclosure, but the lower the quantity. Though it is possible to artificially construct believable arguments about why these relationships are opposed, certain intuitive responses are difficult to overcome – for example, higher levels of assets and liabilities should both lead to increased quantity and quality of disclosure.

Therefore, the key contribution that this study makes is to place some doubt over researchers blindly substituting quantity as an appropriate proxy for quality, especially in a mandatory reporting environment. To put it in other words, as one interviewee (5) argued: “It’s quantity that’s having a [negative] impact on transparency... not quality”. These results indicate that when researchers predict possible relationships between quantity and quality they must ensure that this
relationship actually exists. The study highlights that future research that seeks to justify the use of quantity as a proxy for quality should query this strategy, and conclusions based upon this assumption from prior work should not be accepted *prima facie*.

Table 23: Direction of independent variables (t-stats indicating significance where appropriate; correlation graphs)

<table>
<thead>
<tr>
<th>Hyp.</th>
<th>Variable</th>
<th>Univariate analysis</th>
<th>Multiple analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>QUAN</td>
<td>QUAL</td>
</tr>
<tr>
<td></td>
<td><strong>Information costs variables</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 a&amp;b</td>
<td>MKT</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2 a&amp;b</td>
<td>VOL</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>3 a&amp;b</td>
<td>DIVSH</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>4 a&amp;b</td>
<td>MANOWN</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>5 a&amp;b</td>
<td>INTCOV</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td><strong>Visibility variables</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 a&amp;b</td>
<td>NEWSANALYST</td>
<td>-</td>
<td>***</td>
</tr>
<tr>
<td>7 a&amp;b</td>
<td>O&amp;G</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>8 a&amp;b</td>
<td>MINING</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>9 a&amp;b</td>
<td>SHISSUE</td>
<td>-</td>
<td>*</td>
</tr>
<tr>
<td></td>
<td><strong>Structure related variables</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 a&amp;b</td>
<td>SIZE</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>11 a&amp;b</td>
<td>LEV</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>12 a&amp;b</td>
<td>MKTCAP</td>
<td>-</td>
<td>*</td>
</tr>
<tr>
<td></td>
<td><strong>Performance related variables</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13 a&amp;b</td>
<td>PROF</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>14 a&amp;b</td>
<td>LIQ</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>15 a&amp;b</td>
<td>DERASS</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>16 a&amp;b</td>
<td>DERLIAB</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>17 a&amp;b</td>
<td>VOL</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

*** = significant at 1% level; ** = significant at 5% level; * = significant at 10% level
6.6 Conclusions and recommendations

This chapter has attempted to establish a conceptual framework for the analysis of the quantity and quality of mandatory financial reporting information. It is thought that quantity can be best measured using word count, and quality can be best measured using compliance to an accounting standard on a simple unweighted dichotomous scale. Previous studies have chosen other measures of quality but they are over-reliant on external sources who might potentially be biased or inaccurate, are exposed to the problem that they are constructing an index which cannot capture the whole complexity of the nebulous concept ‘quality’, or design a model which is unworkable in practice on a large scale or for periods greater than one year (Healy and Palepu, 2001; Hassan and Marston, 2010). It is also believed that if mandatory disclosures are not fully complied with, then the information must lack something. To be more specific, that something is surely information usefulness or ‘quality’, i.e. it lacks reliability, relevance, understandability, comparability, verifiability and timeliness.

It is hoped that this proxy for quality might also be used by researchers of voluntary disclosure. Though there are many differences between voluntary and mandatory disclosures, there are also strong similarities – especially public voluntary disclosures that appear in the annual report. As argued in section 5.2, the distinction between voluntarily disclosed information and mandated disclosures is narrowing. Mandatory disclosures normally start as voluntary and the information is mandated when demands are made for consistency, comparability or transparency (e.g. Leuz and Wysocki, 2008; Bushman and Landsman, 2010). Also, there was the feeling amongst the interviewees that much of the voluntary disclosure has become, in effect, mandatory because of pressures for uniformity, comparability and transparency from external sources including investors, analysts and other pressure groups. In addition, it was thought that there was a pressure to disclose information voluntarily when others in the same industry or in a similar position produced information voluntarily. Thus, much of the voluntary information will follow similar patterns. In summary, although this might not be feasible for all types of voluntary disclosure investigation conducted, it is possible that voluntary disclosure researchers (especially those looking at the annual report) could employ compliance
as a measure for quality if a fair and reliable checklist/index were first constructed.¹⁸³ This would be time consuming but might prove worthwhile.

A review was undertaken as to whether IFRS 7 fulfils the objective set out by the IASB, i.e. provides useful information for decision-making purposes. This was achieved through a multi phase process, including a review of the comment letters, then surveying comment letter writers, standard setters, analysts, preparers and auditors and subsequently interviewing several members of these key stakeholder groups. On the whole, timeliness and verifiability aside, there was general agreement that IFRS 7 does capture the key qualitative characteristics and therefore does provide useful information. Thus there is an argument based upon these findings that this measure can act as a suitable proxy for quality in any study of mandatory financial reporting.

The determinants of financial instruments disclosure were explored to assess the drivers of this disclosure. The results indicated that certain variables are statistically significant in determining the levels of disclosure. In the case of quantity it was found that lower levels of managerial ownership and a higher level of News/Analyst following were statistically significant. In terms of quality it was found that higher levels of investor following, marketability, a new share issue during the year and a higher volume of derivative assets held were statistically significant. It is believed that if the sample would have included smaller firms similar results to prior determinants studies would have been found, such as proxies for size, auditor type and listing status.

Though important, these concerns are secondary because they are overshadowed by the directional findings. In many cases it was found that the direction of variables to quantity and quality were in opposition to each other, and that statistical significance to quantity does not necessitate statistical significance to quality. Though one would not go so far as to suggest that all prior studies who have used quantity as a proxy for quality are wrong, future researchers who are using firms’

¹⁸³ In the case of the OFR or MD&A there is already a pre-constructed list of key information requirements but this might be too broad. Also, there are other sections e.g. Chairman’s statement which do not have prescribed content.
annual reports as primary evidence should be urged to consider measures of quality (whether compliance or otherwise) rather than assuming that quantity is an appropriate proxy for quality.
Introduction to Chapter 7

The previous three chapters contribute to the disclosure literature. Chapters 4 and 5 reviewed full, partial, non- and over compliance with the reporting requirements of IFRS 7 providing a possible rationale for disclosure behaviour where possible. Chapter 6 sought to investigate the determinants of the quantity and quality of financial instruments disclosures. In section 2.2.3 the various arguments which have been put forward against mandating reporting requirements were presented. Amongst those was the theory that regulators may be captured to protect the interests of certain groups (Posner, 1974) or regulations instituted to serve the private interests of certain parties (Stigler, 1971; Peltzman, 1976). If this were to be the case for IFRS 7 requirements, and certain groups have the power to demand the inclusion or exclusion of certain requirements, then there is the danger that the conclusions drawn in previous chapters of this thesis could be undermined. This may be the case on the basis that those groups with greater relative strength in the standard setting process could demand the removal of requirements they thought they could not meet or the inclusion of those that they knew they could (to the potential detriment of other groups who do not hold such power).

Chapter 6 presented findings that attempt to analyse which, if any, corporate characteristics significantly determine the quality and quantity of financial instruments disclosures. As the definition of quality is based upon the proxy of compliance – and the assumption that the standard captures the qualitative characteristics which in turn is underpinned by the concept of useful decision making information; and that this process of standard setting occurs fairly and robustly with no bias – then it is necessary to look at the requirements themselves and whether they might have been influenced in the design process. As part of the research conducted, chapter 6 presents a preliminary analysis of responses from comment letters to ED7. Whilst undertaking that review it became apparent that the comment letters were of varying levels of sophistication and there was a considerable probability that all were biased towards their own viewpoint.
If the IASB afforded greater weight to one group of respondents then it would be possible that the standard would be adjusted in such a way that benefited them and thus their compliance percentage. In other words, certain groups could benefit from certain disclosures being removed as requirements because they might be difficult or costly to meet for that specific group. This bias would positively weight disclosures in that group’s favour. In addition, it has been argued that a respondent’s case might be heard more sympathetically where the structure of the letter is largely positive with proposed amendments interspersed. Therefore, the comment letters were reviewed and the relative success of this strategy was also measured. Success was measured as the number of adjustments made after the comment letter process against the number of proposed amendments requested.

The analysis then sought to investigate three concerns. First, whether certain groups (for example professional accounting bodies) or coalitions (for example the regulated industries [e.g. oil and gas]) have greater relative power in the standard setting process. Second, whether respondents from certain geographical areas have greater relative power in the standard setting process. Finally, the hypothesis whether positively worded responses carry greater relative power in the standard setting process was investigated. No evidence was found in relation to the first and third issues. In other words, the IASB appear to have acted fairly and rationally during the (IFRS 7) standard setting process when treating proposed amendments arising from all user groups and do not appear to be influenced by a positive tone. However, the contribution of this study is the finding that the standard setters could be influenced by the geographical origin of the respondent. Certain geographical zones appear to have greater relative power than others.

The implications for the general field of comment letter research are limited. However for this project they are both interesting and encouraging. The compliance review results do not appear to be unfairly prejudiced as a result of the ability of certain groups or coalitions to influence a standard’s requirements before the standard is released.

The side issue that requires further examination for the broader accounting community and literature is the possibility that geographical origin is significant. If the
process is biased against certain groups then this is worrying given the internationalisation of the accounting standard setting process. Future research might like to consider this question more fully by investigating more exposure drafts, their comment letters and their relative success. The process should also be extended to consideration of the non-observable phases of the lobbying process where possible. Also, as discussed in the analysis sections, there are many conclusions that can be drawn from this result and the reported findings might not be due simply to political bias. In addition there are the potential practical problems associated with the private nature of the decision to write comment letters and the comments included therein.
Chapter 7: Comment integration and the relative effectiveness of constituents’ lobbying success

Purpose: There has been a great deal of speculation whether the relative power of certain lobbyists is greater than others dependent upon certain characteristics such as participant size, status, affiliation and coalition involvements. In addition, it has also been argued that comment letters attain greater success in encouraging amendments dependent upon certain discourse strategies, such as tone and strength of argument.

Design/method/approach: The comment letters related to the International Accounting Standards Board’s Exposure Draft 7 Financial Instruments: Disclosures have been examined in detail, and a full reconciliation performed between the requested amendments by the lobbyists and the actual amendments made to the final Standard.

Findings: This study contributes to the literature by noting that, contrary to theory and some prior empirical work, no significance can be found to support the theory that any one lobbying group has significantly greater influence than any other, when considering the likelihood of respondents’ proposed amendments being adopted. The findings also suggest that the IASB act rationally and fairly in the face of certain discourse strategies. However, this investigation does find that comments arising from UK-based organisations and organisations based outside of Europe and the US are significantly less likely to be adopted into the final accounting standard than those from within Europe and the US.

Originality/value: It is important to the study and to accounting research that comment letter analysis has been revisited, as it has been largely set aside in favour of other lobbying research. The value to this project is to ensure that the disclosure requirements are free from bias and are not manipulated by one pressure group over another, thus allowing competitive advantage when it comes to compliance. More holistically, only a small amount of work has been done post European IFRS adoption in 2005.
Keywords: Comment letters; standard setting; due process

7.1 Introduction

The IASB’s standard setting process stresses that it engages in ‘extensive consultation and responsiveness’ (IASCF, 2008; updated 2010: 7). The IASB (2010: 10) state that they undertake “an extensive programme of stakeholder outreach in order to develop a high quality IFRS in a timely manner but also one that has been subjected to rigorous and extensive due process”. This includes multiple formal, informal and feedback consultation methods. The IASB (2010: 2) indicate that they are aware of their responsibility and thus they “actively seek views from all interested parties, both within and outside the financial reporting community. In particular [they] make strenuous efforts to reach out to the investor community, a group that is notoriously difficult to draw into the standard-setting process.”

The due process involves six stages, including: setting the agenda; planning the project; developing and publishing the discussion paper; developing and publishing the exposure draft; developing and publishing the standard; and finally, monitoring and evaluation after the standard is issued. An essential element of this process is communication between stakeholders, especially given the diversity of the constituents (Tokar, 2005). The importance of the outcome of these discussions ensures that the IASB is lobbied at every stage of this standard setting process. If the standard setter chose to deliberately ignore these lobbying activities it would soon lose legitimacy (Wallace, 1990). However, in relation to financial instruments (specifically IAS 39 and the recognition and measurement rules), Walton (2004: 9) noted that the European Commission (EC) have “complained that the IASB does not listen to its constituents”. This study reviews the comment letter stage of the financial instruments disclosures proposals. This stage of the process is critical to the determinants of the content of the final standard, and thus it is this activity that attracts the most attention from lobbyists (and academics) because of its position of importance in terms of chronology, visibility and accessibility.

This is both seen as a technical process and/or a political lobbying process (Zeff, 2002; Whittington, 2005; Durocher et al., 2007), whereby participants seek to
influence outcomes (Sutton, 1984; MacLeay et al., 2000). It has been well documented that the lobbying process itself can take many forms, both observable and non-observable, direct and indirect (Sutton, 1984; Georgiou, 2010). Prior work suggests that there is a significant association between issuing comment letters and other forms of lobbying (Georgiou, 2004) and thus, despite its limitations, the study of comment letters and their contents remains an important area for further attention.

There has been a recent growth of interest related to the use and disclosure of financial instruments, both academically and professionally. Extra disclosure has economic and social implications, but particularly important for this study are the extra costs of preparation incurred by the preparers, audit fee increases for extra time spent and expertise required, plus a potentially greater transparency and/or information overload for financial statement users. Thus one would expect a greater number of comment letters from these user groups and their representatives.

The sudden increase in professional and academic research concerning financial instruments has been triggered by many factors, but in particular the growth in their usage, the complexity of derivatives-based risk management strategies, several high profile corporate collapses and scandals related to the misuse (and abuse) of derivatives, the volatility of exchange rates, interest rates and commodity prices and the transparency (or lack thereof) of the method of accounting for both financial assets and financial liabilities, and their associated gains and losses. It has been argued that disclosure of financial instruments is of equal importance to users’ understandings of position and performance as recognition and measurement (Bradbury, 2003) and in this context the disclosure standard is particularly worthy of consideration.

The analysis of ED 7 complements existing work whilst also making a valuable contribution to the existing literature. Reviews of lobbying have focused on many areas of accounting and therefore have studied different types of standard i.e. presentation, recognition and measurement. Studies of disclosure-only standards remain extremely limited, with the exception being Weetman et al.’s (1996) review of the Accounting Standards Board’s Operating and Financial Review document. However, the OFR document constituted a set of proposals that would be voluntarily
adopted, whereas financial instruments disclosures are mandatory. In addition, this is the first study to investigate lobbying in relation to financial instruments standards, and the first to consider the question of the importance of geographical location in the process of lobbying.

Prior work has principally focused on the incentives to lobby, the decision to lobby and how firms lobby. An overview of the relevant literature shows that there are many unanswered questions related to accounting standards setting and lobbying. However, this paper specifically addresses the following:

1. Who lobbies over financial instruments disclosure issues?
2. Is there evidence that the IASB shows favour to certain participants in the lobbying process over others?
3. Is there evidence of geographical origin bias when a standard setting body amends for comments?
4. What is the relative intensity and direction of the written responses, and does this impact on subsequent amendments?

7.2 Theoretical developments and hypothesis development

Ultimately, lobbyists will gauge whether the opportunity costs of lobbying are less than the expected benefits provided by the lobbying process (rational choice theory). Thus, studies have often explored the question of why certain organisations lobby the standard setters whilst others do not (Watts and Zimmerman, 1978; Kelly, 1983; Francis, 1987; Deakin, 1989). The arguments suggest that there are several identifiable benefits (for participants) to engage in the lobbying process. The primary advantage of lobbying for participants is the opportunity to change a draft set of proposals which otherwise might give rise to an adverse impact on their position or the perception of their position. There are also secondary advantages or opportunities for participating organisations. Audit firms, for example, might lobby in favour of new disclosure regulation because it will create extra work (and thus higher fees) – provided that the benefits to the firm do not significantly outweigh pressure from clients to lobby against new requirements, because of a desire not to prepare and/or disclose the new information (Puro, 1984). In addition, large audit firms are more likely to lobby for new disclosure rules because of the opportunity to put a
greater pressure and burden on the smaller audit firms, whom they assume will be less adaptable (Puro, 1984).

A review of the lobbying literature shows that there are three principal theoretical frameworks underpinning the accounting standards lobbying process, and each holds a potential significance for this study: rational choice theory; the political economy of accounting; and regulatory capture theory. The first of these, rational choice theory (Homans, 1958, 1961; Blau, 1964; Coleman, 1973), suggests that organisations’ decision whether to lobby or not will be based upon their primary pursuit of self-interest (Georgiou, 2004). This creates a two-fold problem: though work has been done to address this issue, it is nevertheless impossible to account for responses that do not exist (Watts and Zimmerman, 1978); and, some responses are unsuccessful and yet they still exist. The second theory is the political economy of accounting framework (Cooper and Sherer, 1984; Sikka, 2001). This has allowed researchers to identify a system that is dominated by several conflicting groups who seek to defend and perpetuate their own interests (Hooks and Moon, 1993; Weetman et al., 1996; Saemann, 1999). Third, regulatory capture theory suggests that the largest companies in certain regulated industries, such as financial institutions or oil and gas entities, capture the regulators and thus exert greater pressure than other stakeholders. Economic theories of regulatory capture have suggested that regulation is sometimes produced in response to demands from the participants (Posner, 1974). Prior work has focused on the relationship between regulatory bodies and the organisations they intend to regulate, and has found that actions are driven by the participants (Mitnick, 1980; Cortese et al., 2010). This might be the result of the dependency of the IASB on funding institutions, who are often the stakeholders in the process (Brown, 2006; Cortese et al., 2010). This study uniquely attempts to address the arguments of the political economy of accounting and regulatory capture theory, whilst at the same time bearing in mind the limitations imposed by the problems associated with rational choice.

Though lobbying literature has several strands, what remains most interesting to the external observer of the process is whether all participants are treated equally – in other words, whether there are significant observable differences in the level of success of certain participants lobbying arguments, and the reasons why some
arguments or participants are more successful than others. The US Financial Accounting Standards Board (FASB) have insisted that all responses are given due consideration (Beresford, 1988), and this sentiment is echoed through the IASB’s publicly available due process documentation. However, research has shown that not all organisations are as persuasive as the next. Beyond the obvious determinants of lobbying strength, such as size and visibility, it has also been shown that successful coalitions are formed between lobbyists. Certain pressure groups, namely professional accounting bodies, have the ability to capture overlapping interests with clients and produce arguments that intertwine with their own preferences (Mitchell and Sikka, 1993; Sikka, Willmott and Lowe, 1989; Sikka, 1992). Cortese et al. (2010) extended this identification using a Critical Discourse Analysis approach, to demonstrate that some organisations acted in coalition in order to help to ensure arguments carried greater clarity and weight. This study further broadens this investigation, and seeks to ascertain whether groups from the most impacted regulated industry acting in consort have a greater effect on the final outcome.

Hypothesis 1a: Professional accounting bodies and large accounting firms will exert greater lobbying pressure and will have a significantly greater number of successful arguments than the other respondent stakeholder groups.

Hypothesis 1b: Regulated parties, such as financial institutions and their representative bodies will have a significantly greater number of successful arguments than those from their unregulated counterparts.

There is a significant potential weakness to these hypotheses. The issue that arises is whether this study falsely generalises the responses of these groups or whether there is a netting off effect between proposals for changes being accepted. Prior work has stated that the audit firms tend to represent their clients interests during this process and that regulated entities and their coalition partners, for example, represent their own interests (e.g. Cortese et al., 2010). It is worth noting that audit firms have developed and nurtured industry and sector specialisms (e.g. Craswell, Francis and Taylor, 1995; Dunn and Mayhew, 2004; Beattie et al., 2003; Hogan and Jetter, 1999; Mayhew and Wilkins, 2003). Therefore, their clients’ interests might differ according to their industry position. It is therefore possible that these responses
are not generalisable. In an attempt to address this question some detailed analysis has been undertaken. The majority of this information is presented in appendix I but a headline summary is provided in table 24.

The information presented shows an analysis of the proposed changes that were amended before the full IFRS 7 was released. These comments have been analysed first by paragraph and secondly by respondent. Preliminary analysis indicates that, though responses from groups are clustered around topics (e.g. insurance professional bodies and insurance preparers made the majority of the comments about conflicts between IFRS 4 and ED 7; whilst banks and financial institutions [both preparers and professional organisations] made the majority of the comments concerning conflicts between IAS 30 and ED 7), those paragraphs which were amended attracted comments from more than one group. It would be foolhardy to simply write off the possibility of a netting off effect or a herding effect amongst responses (particularly as we are not privy to the non-observable phase whereby groups might agree to lobby collectively for greater success) but the evidence of this appears to be limited.

There is some evidence of certain respondents focusing on one issue and occasionally making different proposed changes within that issue. On 15 occasions a respondent has made more than one comment about the same paragraph. This represents 7% of the total number of accepted comments and, though significant, this cannot be considered to be the norm. Balancing this out somewhat it is worth noting that there are changes following proposed amendments from each group across the whole standard.

The highest percentage of comments made by one group (where there was more than one comment) about one proposal related to paragraph 17 asking for clarification over allowance account disclosures where 71.4% (or 5 of 7) came from professional accounting bodies. The weighted average per comment was 25.5% from one group of respondents. With 9 groups – and one of those groups having only one respondent – it would appear that the spread of accepted comments and across topics was within the bounds that could be considered a fair distribution. The number of accepted comments from professional accounting bodies was higher than
the other groups but this arises because professional accounting bodies proposed more changes than the other groups.

The evidence presented in appendix I also serves to highlight that the proposed changes were, in the main, substantial amendments. Most of the occasions where there was a change of a spelling or grammatical mistake in the standard, it can be noted that there were no respondents commenting. The majority of the changes to wording were undertaken by the IASB with nobody asking for the change to be made (69%). The remainder were requested changes and of these, many were specific requests that were accompanied by an explanation. Though these requested changes were broadly grammatical, they were often accompanied by explanations that cited clarification purposes as a rationale and argued that these were required to amend mistakes in the standard. In many cases, these corrections led to significant changes in the meaning of certain disclosure requirements (these are presented in table 25). In previous chapters it has been argued that poorly designed or loosely constructed disclosure requirements could lead to de jure compliance and this standard setting due process is part of the system which seeks to eliminate these problems.

---

184 There is a level of subjectivity in all content analysis (e.g. Weber, 1990; Krippendorff, 2004). The question over whether a proposed change is a change in substance or a change in presentation is another one of those occasions where the researcher is required to use discretion. In this exercise, all cases of clauses, sentences, or words added, plus spelling and grammatical changes made were classed as changes in presentation. However, many of the changes requested were over changes in meaning as a result of the change in the standard (e.g. adding the phrase “...unless the risk is not material” to paragraph 35 significantly shifts the disclosures for some entities. Nevertheless, this argument aside, there were 49 ‘presentational’ changes (after allowing for some grouping e.g. words in the same paragraph and excluding issues such as moving disclosures between paragraphs for logical flow) of which 15 were proposed by the respondents. The remaining 34 were proposed by nobody and were altered as a result, one assumes, of a thorough proof read.

185 See section 1.5 for a brief overview and section 4.4.1 for a discussion of this problem within the context of IFRS 7 compliance issues.
Table 24: Analysis of accepted proposed amendments (grouped) by paragraph and by group

<table>
<thead>
<tr>
<th>Para</th>
<th>Group</th>
<th>No. of amend'ts proposed and accepted</th>
<th>%age of amend'ts</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>PROF / ACC’G</td>
<td>1</td>
<td>33.3%</td>
</tr>
<tr>
<td></td>
<td>PROF / OTHER</td>
<td>1</td>
<td>33.3%</td>
</tr>
<tr>
<td></td>
<td>P / Fi</td>
<td>1</td>
<td>33.3%</td>
</tr>
<tr>
<td>6</td>
<td>PROF / ACC’G</td>
<td>2</td>
<td>40.0%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>1</td>
<td>20.0%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>1</td>
<td>20.0%</td>
</tr>
<tr>
<td></td>
<td>O</td>
<td>1</td>
<td>20.0%</td>
</tr>
<tr>
<td>8</td>
<td>PROF / ACC’G</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td></td>
<td>PROF / OTHER</td>
<td>4</td>
<td>57.1%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td>10</td>
<td>PROF / ACC’G</td>
<td>3</td>
<td>42.9%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td></td>
<td>PROF / INS</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td></td>
<td>PROF / OTHER</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td></td>
<td>O</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td>11</td>
<td>PROF / ACC’G</td>
<td>5</td>
<td>41.7%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>3</td>
<td>25.0%</td>
</tr>
<tr>
<td></td>
<td>PROF / OTHER</td>
<td>3</td>
<td>25.0%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>1</td>
<td>8.3%</td>
</tr>
<tr>
<td>12</td>
<td>PROF / ACC’G</td>
<td>7</td>
<td>53.8%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>3</td>
<td>23.1%</td>
</tr>
<tr>
<td></td>
<td>PROF / INS</td>
<td>1</td>
<td>7.7%</td>
</tr>
<tr>
<td></td>
<td>P / O</td>
<td>1</td>
<td>7.7%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>1</td>
<td>7.7%</td>
</tr>
<tr>
<td>15</td>
<td>PROF / BANK</td>
<td>2</td>
<td>40.0%</td>
</tr>
<tr>
<td></td>
<td>P / Fi</td>
<td>1</td>
<td>20.0%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>2</td>
<td>40.0%</td>
</tr>
<tr>
<td>17</td>
<td>PROF / ACC’G</td>
<td>5</td>
<td>71.4%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td>21</td>
<td>PROF / ACC’G</td>
<td>9</td>
<td>39.1%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>4</td>
<td>17.4%</td>
</tr>
<tr>
<td></td>
<td>PROF / OTHER</td>
<td>2</td>
<td>8.7%</td>
</tr>
<tr>
<td></td>
<td>P / Fi</td>
<td>2</td>
<td>8.7%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>6</td>
<td>26.1%</td>
</tr>
<tr>
<td>24</td>
<td>PROF / ACC’G</td>
<td>1</td>
<td>50.0%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>1</td>
<td>50.0%</td>
</tr>
<tr>
<td>Para</td>
<td>Account Type</td>
<td>Quantity</td>
<td>Percentage</td>
</tr>
<tr>
<td>------</td>
<td>--------------</td>
<td>----------</td>
<td>------------</td>
</tr>
<tr>
<td>26</td>
<td>PROF / ACC'G</td>
<td>1</td>
<td>100.0%</td>
</tr>
<tr>
<td>27</td>
<td>PROF / ACC'G</td>
<td>2</td>
<td>25.0%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>3</td>
<td>37.5%</td>
</tr>
<tr>
<td></td>
<td>P / Fi</td>
<td>2</td>
<td>25.0%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>1</td>
<td>12.5%</td>
</tr>
<tr>
<td>29</td>
<td>PROF / ACC'G</td>
<td>1</td>
<td>100.0%</td>
</tr>
<tr>
<td>35</td>
<td>PROF / ACC'G</td>
<td>3</td>
<td>42.9%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>2</td>
<td>28.6%</td>
</tr>
<tr>
<td></td>
<td>P / Fi</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>1</td>
<td>14.3%</td>
</tr>
<tr>
<td>39</td>
<td>PROF / ACC'G</td>
<td>2</td>
<td>13.3%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>1</td>
<td>7.7%</td>
</tr>
<tr>
<td></td>
<td>PROF / OTHER</td>
<td>3</td>
<td>23.1%</td>
</tr>
<tr>
<td></td>
<td>P / Fi</td>
<td>4</td>
<td>36.4%</td>
</tr>
<tr>
<td></td>
<td>P / INS</td>
<td>1</td>
<td>12.5%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>4</td>
<td>57.1%</td>
</tr>
<tr>
<td>40</td>
<td>PROF / ACC'G</td>
<td>1</td>
<td>33.3%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>1</td>
<td>33.3%</td>
</tr>
<tr>
<td></td>
<td>P / O</td>
<td>1</td>
<td>33.3%</td>
</tr>
<tr>
<td>42</td>
<td>PROF / BANK</td>
<td>2</td>
<td>66.7%</td>
</tr>
<tr>
<td></td>
<td>P / O</td>
<td>1</td>
<td>33.3%</td>
</tr>
<tr>
<td>43</td>
<td>PROF / ACC'G</td>
<td>1</td>
<td>20.0%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>1</td>
<td>20.0%</td>
</tr>
<tr>
<td></td>
<td>PROF / OTHER</td>
<td>2</td>
<td>40.0%</td>
</tr>
<tr>
<td></td>
<td>P / Fi</td>
<td>1</td>
<td>20.0%</td>
</tr>
<tr>
<td>44</td>
<td>PROF / ACC'G</td>
<td>5</td>
<td>23.8%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>7</td>
<td>33.3%</td>
</tr>
<tr>
<td></td>
<td>PROF / OTHER</td>
<td>3</td>
<td>14.3%</td>
</tr>
<tr>
<td></td>
<td>P / Fi</td>
<td>3</td>
<td>14.3%</td>
</tr>
<tr>
<td></td>
<td>P / O</td>
<td>3</td>
<td>14.3%</td>
</tr>
<tr>
<td>46</td>
<td>PROF / ACC'G</td>
<td>10</td>
<td>41.7%</td>
</tr>
<tr>
<td></td>
<td>PROF / BANK</td>
<td>3</td>
<td>12.5%</td>
</tr>
<tr>
<td></td>
<td>PROF / INS</td>
<td>1</td>
<td>4.2%</td>
</tr>
<tr>
<td></td>
<td>PROF / OTHER</td>
<td>3</td>
<td>12.5%</td>
</tr>
<tr>
<td></td>
<td>P / Fi</td>
<td>2</td>
<td>8.3%</td>
</tr>
<tr>
<td></td>
<td>P / INS</td>
<td>1</td>
<td>4.2%</td>
</tr>
<tr>
<td></td>
<td>P / O</td>
<td>1</td>
<td>4.2%</td>
</tr>
<tr>
<td></td>
<td>AUD</td>
<td>2</td>
<td>8.3%</td>
</tr>
<tr>
<td></td>
<td>O</td>
<td>1</td>
<td>4.2%</td>
</tr>
</tbody>
</table>
Para 47

<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROF / ACC’G</td>
<td>3</td>
<td>33.3%</td>
</tr>
<tr>
<td>PROF / BANK</td>
<td>1</td>
<td>11.1%</td>
</tr>
<tr>
<td>PROF / INS</td>
<td>3</td>
<td>33.3%</td>
</tr>
<tr>
<td>O</td>
<td>2</td>
<td>22.2%</td>
</tr>
</tbody>
</table>

Para 48

<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROF / ACC’G</td>
<td>3</td>
<td>18.8%</td>
</tr>
<tr>
<td>PROF / BANK</td>
<td>3</td>
<td>18.8%</td>
</tr>
<tr>
<td>PROF / INS</td>
<td>1</td>
<td>6.3%</td>
</tr>
<tr>
<td>PROF / OTHER</td>
<td>5</td>
<td>31.3%</td>
</tr>
<tr>
<td>p / Fi</td>
<td>1</td>
<td>6.3%</td>
</tr>
<tr>
<td>AUD</td>
<td>2</td>
<td>12.5%</td>
</tr>
<tr>
<td>O</td>
<td>1</td>
<td>6.3%</td>
</tr>
</tbody>
</table>

Para 49

<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROF / ACC’G</td>
<td>1</td>
<td>16.7%</td>
</tr>
<tr>
<td>PROF / INS</td>
<td>2</td>
<td>33.3%</td>
</tr>
<tr>
<td>PROF / OTHER</td>
<td>3</td>
<td>50.0%</td>
</tr>
</tbody>
</table>

General comments

<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROF / BANK</td>
<td>3</td>
<td>42.9%</td>
</tr>
<tr>
<td>PROF / OTHER</td>
<td>2</td>
<td>28.6%</td>
</tr>
<tr>
<td>AUD</td>
<td>2</td>
<td>28.6%</td>
</tr>
</tbody>
</table>

Table 25 Amended proposals related to grammatical issues

| Para 8            | Clause reworded to read: "An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position."
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Para 11</td>
<td>Wording change: “financial liability” deleted and replaced with “loan or receivable (or group of loads or receivables)”</td>
</tr>
<tr>
<td>Para 13</td>
<td>Added quantitative requirement to qualitative requirement. Initially asked to disclose “the reason for that reclassification” latterly asked for “the amount reclassified into and out of each category and the reason for that reclassification.”</td>
</tr>
<tr>
<td>Para 15</td>
<td>Used to read: “pledged as collateral for liabilities” Added to the end of this: “…or contingent, including amounts that have been reclassified in the balance sheet separately from other assets as the transferee has the right to sell or repledge the collateral”</td>
</tr>
<tr>
<td>Para 15</td>
<td>Change ‘assets’ to ‘financial assets’</td>
</tr>
<tr>
<td>Para 21</td>
<td>ai. Wording change: from “designated as FV through Profit or loss” to “designated as such on initial recognition and those on FAs or FLs that are classified as held for trading”</td>
</tr>
<tr>
<td>Para 21</td>
<td>d. Minor grammatical changes including separate recognition (‘and’ for ‘or’)</td>
</tr>
<tr>
<td>Para 23</td>
<td>23f (moved to g): Additional clause about ‘objective evidence’ to be disclosed in relation to impairment losses.</td>
</tr>
<tr>
<td>Para 23</td>
<td>23g: Additional clarificatory clause about renegotiated terms for financial assets on those that would ordinarily be recorded as past due or impaired.</td>
</tr>
<tr>
<td>Para 24</td>
<td>Changed list of hedge categories to: “for each type of hedge”</td>
</tr>
<tr>
<td>Para 27</td>
<td>27a: Wording changes for clarification purposes but this disclosure was previously required in ED7.31</td>
</tr>
<tr>
<td>Para 35</td>
<td>35b: Changed “the minimum disclosures”; deleted the word “minimum”</td>
</tr>
</tbody>
</table>
and replaced with the phrase: “the disclosures... unless the risk is not material.”

<table>
<thead>
<tr>
<th>Para 40</th>
<th>40a: Added the phrase: &quot;individually determined to be&quot; impaired</th>
</tr>
</thead>
<tbody>
<tr>
<td>Para 40</td>
<td>40c – wording changes. Wording changes to clarify what is required and to acknowledge that fair values might be estimates.</td>
</tr>
<tr>
<td>Para 43</td>
<td>Wording change to ensure that an entity reports each type of market risk to which it is exposed</td>
</tr>
</tbody>
</table>

As a further extension to the hypothesis that certain organisations might have a significantly more powerful voice, is the argument that comments arising from certain geographical areas might carry a disproportionately greater weight. It is commonly thought that the UK and the Accounting Standards Board, and the US and the FASB, hold a privileged position in the standard setting process. A review of the lobbying literature suggests that no study has explored this issue. One would predict that the IASB, being an international standard setter, would listen to all opinions regardless of their origin; however, the hypothesis being tested is as follows:

Hypothesis 2: Organisations classified as incorporated or based in the UK or the US have a significantly greater number of successful arguments than those from other geographical areas.

Prior comment letter studies have classified respondents into supportive and non-supportive, dependent upon the overall position of their comment letters (Puro, 1984; Deegan et al., 1990; Tutticci et al., 1994). This has become relatively common practice for researchers investigating comment letter-based lobbying. However, it has been noted that participants tend not to focus on one issue but a range of arguments, comments and discussions (Yen et al., 2007), and classifying something as being generally supportive or unsupportive is too loose an association. Therefore, in common with prior studies (such as Weetman et al., 1996) this paper weights responses according to a level of support categorising each letter. The adopted (Likert style) scale runs from 1 (fundamental objections) to 7 (highly supportive) (see Section 7.4 for further details). Using this distribution, one can test whether, as is commonly believed, a letter which is predominantly positive is more likely to have more successful arguments than a letter that is predominantly negative.
Hypothesis 3: Comment letters that are predominantly positive have a significantly greater number of successful arguments than those which are predominantly negative.

7.3 The development of financial instruments disclosures regulation

A more complete review of the development of IFRS 7 can be seen in Chapter 1. However, some of those points are worth repeating here before the analysis takes place, to set the Standard in context. Prior to 1993 and the issue of FRS 4 in the UK, there was no effective guidance on accounting for financial instruments for FTSE 100 companies. Companies were therefore free to disclose as little or as much as they wished and in practice used a wide range of disclosure methods. As a result of this accounting gap, the financial statements of a company could be rendered meaningless by the non-disclosure of a financial instrument that could have a material impact on the Balance Sheet or Income Statement. A series of derivatives related corporate collapses made the accounting standard setters move sharply. The issues, broadly speaking, linked to information asymmetry and were twofold: large, but previously undisclosed, losses were realised; and equity became extremely volatile as a result of real or potential fears of unhedged, and mostly off-balance, sheet instruments.

This triggered a great deal of work, which has continued throughout the last two decades to make disclosure requirements as comparable and transparent as possible. This has been part of a global programme of events and the FASB have played a strong hand in proceedings to ensure that US GAAP does not differ too substantially from IFRS and vice-versa. IAS 30 was the first full International Accounting Standard to deal with financial instruments, but it applied exclusively to banks and financial institutions and dealt almost entirely with disclosures. IAS 32 and IAS 39 on the other hand were also to be adopted by non-financial firms, and these standards were adopted by European listed consolidated entities for years commencing on or after 1 January 2005. IAS 39 dealt with the issues of recognition and measurement, whilst IAS 32 held the presentation and disclosure requirements. IAS 32 was revised to contain solely presentation requirements and IFRS 7 now captures all of the disclosure requirements. IFRS 7 became effective for years
commencing on or after 1 January 2007 and included many of the IAS 32 requirements and some additional requirements. Unlike IAS 32 and IAS 39, there are no immediate plans to substantively change IFRS 7.

7.4 Research methods

ED 7 attracted 106 comment letters, which averaged 6.8 pages in length and included an average of 22 separately identifiable comments per letter (Table 26). The number of comment letters on a proposed (IASB) accounting standard varies significantly; however, it is commonplace for there to be between 80 and 120, and therefore this puts ED 7 into the higher band (Yen et al., 2007). Following prior research, participants were grouped into appropriate categories according to affiliation. As with prior studies of this nature, groupings were subjectively decided (Weetman et al., 1996) and this review simply isolates the groups which are both important to the context and field, and which have critical mass for measurement purposes.

The findings reflect a multi-phased content analysis approach. However, before any formal analysis within QSR International NVivo was undertaken; an initial random selection of 10 letters were read through in detail and annotated by hand to ensure that the process of analysis would be consistent from the outset. Methodological studies of content analysis have suggested that this is often a chief cause of inconsistency in the findings. Following this initial review, the comment letters were individually analysed according to the type of comment being made, consistent with prior studies i.e. theoretically oriented, outcome oriented, or other arguments (Yen et al., 2007). Comments made by respondents were both positive and negative in all categories and both applauded and criticised the proposals set out in ED 7.

The outcome-oriented comments were classified under three broad sub-headings – notably: additional disclosures required; clarification required; and clearer guidance

---

186 These additional requirements are set out in ED 7 and the IASB requested these to be considered by respondents. In addition, the IASB received feedback on any requirements which were excluded from ED 7 which were previously included in IAS 30 or IAS 32. Additionally, the IASB asked for comments from respondents on whether they felt that the excluded comments from US GAAP should be adopted into the financial instruments disclosures standard also.
required. Each comment coded to these categories was then further analysed according to precisely what specific points changes were requested on. Extra guidance, changes, or additions were requested in relation to virtually every paragraph of the ED.

Once the required changes had been categorised and classified, the changes between ED 7 and IFRS 7 were reviewed through a simple ‘track changes’ approach on Microsoft Word, by taking the original text of ED 7 and amending each paragraph so that it was consistent to the first full release of IFRS 7. Where respondents had requested changes to be made to the IFRS, and these had been implemented, then this was noted as a successful comment.

To gauge the intensity or strength of a response, letters were firstly classified as either predominantly positive or negative. As Brown (1981) noted, there is a great deal of subjectivity in classifying a comment letter as supportive or otherwise, and therefore a second tier of analysis has been introduced to capture the relative strength of the response. A scale was devised to measure the strength of the arguments within the response as follows:

7 Full support for the proposed regulations with few minor comments or suggestions
6 High level of support but multiple minor objections or opposition to one major issue
5 Supportive but with objections to both minor and major issues
4 Neutral
3 Critical but no major objections
2 Highly critical with multiple minor objections or opposition to one major issue
1 Fundamental objections to the proposals with few, if any, supportive comments
Table 26: Ranked responses

<table>
<thead>
<tr>
<th>Interest Group</th>
<th>No. of responses</th>
<th>Rank</th>
<th>No. of pages</th>
<th>Average no. of pages</th>
<th>Rank</th>
<th>No. of classified comments by coder</th>
<th>Average no. of comments</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional bodies: Accounting</td>
<td>32</td>
<td>1</td>
<td>213</td>
<td>6.7</td>
<td>6</td>
<td>695</td>
<td>21.7</td>
<td>4</td>
</tr>
<tr>
<td>Professional bodies: Banking</td>
<td>20</td>
<td>2</td>
<td>147</td>
<td>7.4</td>
<td>3</td>
<td>418</td>
<td>20.9</td>
<td>5</td>
</tr>
<tr>
<td>Professional bodies: Other</td>
<td>16</td>
<td>3</td>
<td>111</td>
<td>6.9</td>
<td>4</td>
<td>366</td>
<td>22.9</td>
<td>3</td>
</tr>
<tr>
<td>Preparers: Banks and financial institutions (excl insurance)</td>
<td>11</td>
<td>4</td>
<td>64</td>
<td>5.6</td>
<td>7</td>
<td>218</td>
<td>19.8</td>
<td>6</td>
</tr>
<tr>
<td>Professional bodies: Insurance</td>
<td>9</td>
<td>5</td>
<td>60</td>
<td>6.7</td>
<td>5</td>
<td>153</td>
<td>17.0</td>
<td>8</td>
</tr>
<tr>
<td>Preparers: Insurance</td>
<td>7</td>
<td>6</td>
<td>32</td>
<td>4.6</td>
<td>8</td>
<td>111</td>
<td>15.9</td>
<td>9</td>
</tr>
<tr>
<td>Preparers: Other</td>
<td>5</td>
<td>7</td>
<td>21</td>
<td>4.2</td>
<td>9</td>
<td>88</td>
<td>17.6</td>
<td>7</td>
</tr>
<tr>
<td>Accounting firms</td>
<td>5</td>
<td>8</td>
<td>43</td>
<td>8.6</td>
<td>2</td>
<td>222</td>
<td>44.4</td>
<td>2</td>
</tr>
<tr>
<td>Other – unaffiliated</td>
<td>1</td>
<td>9</td>
<td>25</td>
<td>25.0</td>
<td>1</td>
<td>72</td>
<td>72.0</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>106</td>
<td>7</td>
<td>716</td>
<td></td>
<td></td>
<td>2,343</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

As with any study of this type where there is subjectivity in the analysis process, there are weaknesses both methodologically and in design (Beattie and Thomson, 2007; Uneman, 2000; Milne and Adler, 1999; Hackston and Milne, 1996). Content analysis can be criticized on many levels but principally because, as Weber (1990: 62) noted, ‘interpretation [of text] is in part an art’. Krippendorff (2004) addressed these concerns and identified the reliability issue – in other words, that coding text suffers from a potential lack of stability, accuracy and reproducibility. The accepted way to mitigate against these issues is to allow unconnected parties to separately code the text and then compare the results of their analysis with the original. In this case, an independent expert undertook a coding exercise for six of the letters (each containing more than the average number of comments). A list of possible coding categories was given to the coder to ensure the results could be consistent.\(^{187}\) The results of this sensitivity analysis were satisfactory. The Kappa coefficients for inter-coder reliability ranged from $\kappa = 0.64$ to $\kappa = 0.92$ and all were significant at conventional levels. This indicates that the results of the coding exercise are robust. All differences arose from different interpretations of text and occasional duplication in coding to categories. These variations were reviewed by the original coder and changes were made where considered necessary. As these results indicate, a key limitation of this type of research is that the levels of subjectivity in the coding imply that there is no guarantee of achieving identical results if one replicated the study.\(^{188}\) However, the checks performed provide some comfort regarding the consistency of a high level of coding standards.

\(^{187}\) Otherwise each coder would need to spend a vast amount of time setting up a completely new coding system, and this is not the purpose of the sensitivity analysis.

\(^{188}\) See Milne and Adler (1999) for further discussions on this coding reliability issue.
Table 27: Classification of comments: Analysis of arguments

<table>
<thead>
<tr>
<th>Theoretical arguments</th>
<th>No. of classified comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comparability</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>67</td>
</tr>
<tr>
<td>Positive</td>
<td>113</td>
</tr>
<tr>
<td>Fair representation (Reliable)</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>50</td>
</tr>
<tr>
<td>Positive</td>
<td>55</td>
</tr>
<tr>
<td>Relevance</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>225</td>
</tr>
<tr>
<td>Positive</td>
<td>183</td>
</tr>
<tr>
<td>Timeliness</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>10</td>
</tr>
<tr>
<td>Positive</td>
<td>9</td>
</tr>
<tr>
<td>Understandability</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>171</td>
</tr>
<tr>
<td>Positive</td>
<td>75</td>
</tr>
<tr>
<td>Verifiability</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>26</td>
</tr>
<tr>
<td>Positive</td>
<td>2</td>
</tr>
</tbody>
</table>

Outcome oriented arguments (note 1)

<table>
<thead>
<tr>
<th>Outcome oriented arguments</th>
<th>No. of classified comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clarification required</td>
<td>177</td>
</tr>
<tr>
<td>Additional disclosures required</td>
<td>155</td>
</tr>
<tr>
<td>Clearer guidance required</td>
<td>232</td>
</tr>
</tbody>
</table>

Other arguments

<table>
<thead>
<tr>
<th>Other arguments</th>
<th>No. of classified comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conflict with IFRS 4 arguments</td>
<td>92</td>
</tr>
<tr>
<td>Detracts from annual report credibility</td>
<td>11</td>
</tr>
<tr>
<td>Comments on SFAS omissions from ED 7</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>6</td>
</tr>
<tr>
<td>Neutral</td>
<td>1</td>
</tr>
<tr>
<td>Positive</td>
<td>58</td>
</tr>
<tr>
<td>Immaterial/lack of usefulness</td>
<td>119</td>
</tr>
<tr>
<td>Location of disclosures</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>76</td>
</tr>
<tr>
<td>Neutral</td>
<td>1</td>
</tr>
<tr>
<td>Positive</td>
<td>38</td>
</tr>
<tr>
<td>Unaudited</td>
<td>53</td>
</tr>
<tr>
<td>Unaudited but cross referenced</td>
<td>3</td>
</tr>
<tr>
<td>Implementation practicality issues and problems</td>
<td>226</td>
</tr>
<tr>
<td>Requires greater flexibility</td>
<td>32</td>
</tr>
<tr>
<td>Transparency</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>10</td>
</tr>
<tr>
<td>Positive</td>
<td>9</td>
</tr>
<tr>
<td>Other comments</td>
<td>58</td>
</tr>
</tbody>
</table>

2,343
Note 1: Reconciliation of outcome oriented arguments

Outcome oriented arguments
- Clarification required: 177
- Additional disclosures required: 155
- Clearer guidance required: 232
- Call for requirement but either not specific or deemed out of context: 564

Ordinary least squares regression analysis was adopted to examine (beyond a descriptive level) the hypotheses outlined above with greater accuracy. The basic models adopted were twofold. The first model groups respondents according to their affiliations, thus testing the hypothesis (H1) that professional accounting bodies and large accounting firms exert more control, as explained by the political economy of accounting arguments, and whether the strength of comment is a significant determinant of whether proposed amendments are adopted (H3).

\[
\text{Adoption of proposed amendment} = \alpha_0 + \beta_1 \text{Comment} + \beta_2 \text{Professional: Accounting} + \\
\beta_3 \text{Professional: Banking} + \beta_4 \text{Professional: Other} + \beta_5 \text{Accounting Firms} + \\
\beta_6 \text{Preparers} + \beta_7 \text{UK} + \beta_8 \text{Europe} + \beta_9 \text{US} + \epsilon
\]

The second model tests the theory that regulated industries form coalitions and are thus stronger by association (H2), and whether the strength of comment is a significant determinant of whether proposed amendments are adopted (H3).

\[
\text{Adoption of proposed amendment} = \alpha_0 + \beta_1 \text{Comment} + \beta_2 \text{Professional Accounting plus accounting firms} + \\
\beta_3 \text{Professional Banking plus banking preparers} + \\
\beta_4 \text{Professional Insurance and insurance preparers} + \\
\beta_5 \text{Professional Other plus other organisations} + \beta_6 \text{UK} + \beta_7 \text{Europe} + \\
\beta_8 \text{US} + \epsilon
\]

7.5 Findings

7.5.1 Preliminary analysis

As Table 26 shows, the professional bodies produce the greatest volume of responses (73%) whilst preparers and audit firms make up almost all of the remainder. Only one letter was generated by an unaffiliated individual. This is not
inconsistent with prior reviews. Other studies have found there to be more preparers and professional bodies commenting, whilst users are consistently under-represented (Sutton, 1984; Weetman et al., 1996; Harding and McKinnon, 1997). In terms of audit firms, only the Big Four plus Grant Thornton issued responses. Accounting firms produced longer than average responses, which contained more comments and concerns. Comments made by preparers tended to focus on one-off issues and this review found significant overlap between the arguments made by corporate (preparer) participants and the arguments made by their representative professional bodies. To accompany this analysis, table 25 and appendix I provide evidence that there was a relatively even distribution of comments. Where there were large clusters of comments from across the range of groups, adjustments were made e.g. the capital requirements (paragraphs 46-48). There is also evidence of amendments being made despite only being requested by one respondent e.g. paragraph 26 where the scope was amended for location of disclosure and paragraph 29 where a requirement was added dealing with financial assets and financial liabilities where the carrying value is a reasonable approximation of the fair value.

The results are consistent with prior studies in that they show that each group approached the submission of comment letters differently. The responses in Table 26 were tested in terms of average number of pages, average number of comments and average number of proposed amendments. To identify whether these were different, Kruskal-Wallis one-way analyses of ranks tests were performed. The results confirmed that there was a significant difference in terms of average number of pages (p < 0.01), average number of comments (p < 0.01) and average number of proposed amendments (p < 0.05) among respondent groups.

Table 28 shows a positive weighting to the distribution with 66% (70) of responses being broadly positive about the proposals. Further analysis of the strength of response shows that positive letters tended to be broadly positive, whereas negative responses tend to be highly critical. As the analysis shows, the professional bodies seem to adhere to the rhetorical conceptual framework that argues that a balanced positive letter which makes occasional negative comments will have more effect on the outcome. The negative responses from the classification ‘professional bodies:'
other’ consistently reiterated their opposition to the fact that these proposals appeared to be aimed at financial institutions. They noted that the proposals would bring a disproportionately negative cost-benefit payoff for SME’s and non-financial firms.

The financial institutions who responded broadly agreed with the proposals and applauded combining IAS 30 disclosure requirements with IAS 32 into a new IFRS. However, they frequently noted the problems with the capital disclosures being proposed in the ED. The other unaffiliated respondent wrote a 25 page letter including 72 comments which were all resoundingly negative.

Table 28: Summary of respondent attitudes

<table>
<thead>
<tr>
<th>Interest Group</th>
<th>+ive</th>
<th>Neutral</th>
<th>-ive</th>
<th>7</th>
<th>6</th>
<th>5</th>
<th>4</th>
<th>3</th>
<th>2</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional bodies: Accounting</td>
<td>24</td>
<td>4</td>
<td>4</td>
<td>1</td>
<td>7</td>
<td>16</td>
<td>4</td>
<td>1</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Professional bodies: Banking</td>
<td>13</td>
<td>1</td>
<td>6</td>
<td>0</td>
<td>2</td>
<td>11</td>
<td>1</td>
<td>1</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>Professional bodies: Insurance</td>
<td>6</td>
<td>0</td>
<td>3</td>
<td>0</td>
<td>1</td>
<td>5</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Professional bodies: Other</td>
<td>8</td>
<td>1</td>
<td>7</td>
<td>0</td>
<td>5</td>
<td>3</td>
<td>1</td>
<td>6</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Preparers: Banks and financial institutions (excl insurance)</td>
<td>8</td>
<td>0</td>
<td>3</td>
<td>0</td>
<td>1</td>
<td>7</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Preparers: Insurance</td>
<td>5</td>
<td>0</td>
<td>2</td>
<td>0</td>
<td>3</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Preparers: Other</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>2</td>
<td>0</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Accounting firms</td>
<td>4</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>3</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Other – unaffiliated</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>70</strong></td>
<td><strong>8</strong></td>
<td><strong>28</strong></td>
<td><strong>1</strong></td>
<td><strong>20</strong></td>
<td><strong>49</strong></td>
<td><strong>8</strong></td>
<td><strong>9</strong></td>
<td><strong>13</strong></td>
<td><strong>6</strong></td>
</tr>
</tbody>
</table>

In total, 80 respondents (75%) requested that 476 specific changes be made to the proposals, and Table 29 summarises the successes of these outcome-oriented arguments by respondent affiliation and geographical origin. Of this total, almost half (210; 44.1%) of the proposed changes were actioned. This appears to be a high proportion but is broadly in line with prior studies. McEnroe (1993) found that “the success rate for the integration of the comments ranged from 20 per cent for the medium-size firms to 43.7 per cent for the large firms.”

---

189 These paragraphs (ED 7: 46–46) were removed and will be dealt with separately by the IASB.
Larson (2007) related Kwok’s (1999) findings when he investigated the relative power of user groups. Kwok found that despite the existence of a mixed power model, the IASC would be unlikely to set regulations which were adverse to preparers. Subsequently, Kwok and Sharp (2005) found that preparers were more influential than other groups. The descriptive statistics in relation to outcome oriented arguments towards ED 7, and the relative influence of constituents on the IASB, do not confirm that any particular group had greater power over another. However, the insurance companies did have a low percentage of successful arguments (20%), but this is partly due to the specificity and relative complexity of their requested amendments alongside the limited number of comments themselves (10). There were two successful comments: one was a straightforward clarificatory request for an explanatory paragraph related to paragraph 39; the other argued that the disclosure requirements related to internal capital did not have a place in IFRS 7 and these paragraphs were deleted (paragraphs 46-48). Those which were not amended related to the following: a deletion of the sensitivity analysis disclosures (irrelevant information; insurance companies earnings mismatch; a change to the fair value disclosures; a change to phraseology regarding credit risk; and a deletion of credit risk exposure disclosures.

The comment letter responses range in levels of detail, bias and sophistication. Thus, any comparison between these responses is fraught with problems and limitations. For added robustness, future research should ensure that there is more than one exposure draft examined and that the respondents are both different and the same as those for the original exposure draft examined. Though the comments appear to be evenly distributed any conclusions drawn here are preliminary. The reason that only one exposure draft is studied in the context of this project is because of the specific and absolute relevance to this study of this exposure draft and changes made to the standard.

The other group who were seemingly less successful was the accounting firms, who in actual terms proposed 82 amendments, of which only 26 were accepted and made (32%). These amendments were spread throughout the standard and the
accepted changes related to 14 separate paragraphs.\footnote{Appendix I shows that the comments from accounting firms that were accepted related to different topics. The analysis shows that the 27 successful responses from auditors (number of responses in brackets) break down as follows: paragraph 6 (1); paragraph 8 (1); paragraph 11 (1); paragraph 12 (1); paragraph 15 (2); paragraph 17 (1); paragraph 21 (6); paragraph 24 (1); paragraph 27 (1); paragraph 35 (1); paragraph 39 (4); paragraph 46 (2); paragraph 48 (2); general comments (2).} It is worth noting that only two other groups had more arguments accepted in actual terms: the professional accounting bodies (67) and the professional banking organisations (43). The group with the highest percentage of successful comments was banks and financial institutions (excluding insurance companies) (56%). In addition, the analysis appears to show that there is no geographical bias, and proposed amendments are considered similarly.

There is no immediate evidence that there is bias towards any group or origin. On an initial examination at a surface level, every group and every geographical origin has had proposed amendments accepted and no grouping has proposed amendments which have not been considered. It would appear that the IASB have acted rationally and fairly by accepting and rejecting proposed amendments from all respondents.

One of the interviewees (6) was a member of the board of the IASB\footnote{As at September 2009} and in response to the question about the fairness and veracity of the comment review process reinforced the point that the IASB acted fairly and rationally. This is as we might expect given the role but it is interesting to note the wording of the following statement which does not wholly mitigate the possibility for bias towards or against certain groups.

\begin{quote}
“Here most of the board members have given their opinion that this is the way to do it, and then I think you can say that the response… but the responses that are popular, that divides into two buckets. Half the board would like to have that solution and the other half of the board would like the other solution. How many letters do I have in my bucket? Who is supporting my opinion? And even though if it’s empty, a lot of people say that, OK, I have read the letters, we try to read, not all of them, because now we have so many responses but we read most of the letters that we think have value and we get advice from
\end{quote}
staff, I mean this is a full considered agreement between staff and they make a summary for us. So I think that all opinions are being brought forward and that’s important, but, then you know, yes, staff and people are staff and people.”
Table 29: Analysis of changes requested and their relative success

<table>
<thead>
<tr>
<th>No</th>
<th>Additional disclosures required</th>
<th>Clearer guidance required</th>
<th>Clarification required</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Professional bodies: Accounting</td>
<td>146</td>
<td>23</td>
<td>23</td>
</tr>
<tr>
<td></td>
<td>Professional bodies: Banking</td>
<td>96</td>
<td>20</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Professional bodies: Insurance</td>
<td>18</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Professional bodies: Other</td>
<td>67</td>
<td>8</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Preparers: Banks and financial institutions (excl insurance)</td>
<td>32</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Preparers: Insurance</td>
<td>10</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Preparers: Other</td>
<td>14</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Accounting firms</td>
<td>82</td>
<td>17</td>
<td>21</td>
</tr>
<tr>
<td></td>
<td>Other – unaffiliated</td>
<td>11</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Yes</th>
<th>Additional disclosures required</th>
<th>Clearer guidance required</th>
<th>Clarification required</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Professional bodies: Accounting</td>
<td>146</td>
<td>23</td>
<td>23</td>
</tr>
<tr>
<td></td>
<td>Professional bodies: Banking</td>
<td>96</td>
<td>20</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Professional bodies: Insurance</td>
<td>18</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Professional bodies: Other</td>
<td>67</td>
<td>8</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Preparers: Banks and financial institutions (excl insurance)</td>
<td>32</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Preparers: Insurance</td>
<td>10</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Preparers: Other</td>
<td>14</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Accounting firms</td>
<td>82</td>
<td>17</td>
<td>21</td>
</tr>
<tr>
<td></td>
<td>Other – unaffiliated</td>
<td>11</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>
Table 30: Descriptive statistics

<table>
<thead>
<tr>
<th>Yes (%)</th>
<th>Strength of comment (1-7)</th>
<th>Professional: Accounting (1/0)</th>
<th>Professional: Banking and insurance (1/0)</th>
<th>Professional: Other (1/0)</th>
<th>Accounting firms (1/0)</th>
<th>Preparers (all) (1/0)</th>
<th>Europe (excl UK) (1/0)</th>
<th>US (1/0)</th>
<th>Other geographical origin (1/0)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>80</td>
<td>80</td>
<td>24</td>
<td>22</td>
<td>11</td>
<td>5</td>
<td>17</td>
<td>15</td>
<td>37</td>
</tr>
<tr>
<td>Min</td>
<td>0%</td>
<td>1.0</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Max</td>
<td>100%</td>
<td>6.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Mean</td>
<td>44%</td>
<td>4.2</td>
<td>0.3</td>
<td>0.3</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.5</td>
<td>0.2</td>
</tr>
<tr>
<td>Std Dev</td>
<td>0.3</td>
<td>1.5</td>
<td>0.5</td>
<td>0.4</td>
<td>0.3</td>
<td>0.2</td>
<td>0.4</td>
<td>0.5</td>
<td>0.4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Professional: Accounting &amp; accounting firms (1/0)</th>
<th>Professional: Banking &amp; banking preparers (1/0)</th>
<th>Professional: Insurance &amp; insurance preparers (excluding unaffiliated) (1/0)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>28</td>
<td>23</td>
</tr>
<tr>
<td>Min</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Max</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Mean</td>
<td>0.4</td>
<td>0.3</td>
</tr>
<tr>
<td>Std Dev</td>
<td>0.5</td>
<td>0.5</td>
</tr>
</tbody>
</table>
7.5.2 Regression results

Ordinary least squares regression analysis was undertaken to establish the significance of certain determinants in the adoption of proposed changes. The dependent variable is a continuous measure of success (1 to 100) whilst the independent variables relate directly to the hypotheses outlined in Section 7.4. Hypotheses 1 and 2 use dichotomous dummy variables (1/0) for the grouping and geographical origin respectively. Hypothesis 3 uses the strength of response shown in Table 28. Table 31 shows the strength of correlations between the variables and Table 32 presents the results of the regression analysis.

The analysis has been broken up into two basic models. The first model groups respondents according to their affiliations, thus attempting to test the first hypothesis (H1a) – that professional accounting bodies and accounting firms exert more control, as explained by the political economy of accounting arguments. The second model tests the theory that regulated industries form coalitions and are thus stronger by association (H1b). Independent variables were omitted due to issues of multicollinearity (producing variance inflation factors (VIF) of greater than 5 [see for example Pearson, 2010; or Gujarati, 2003]). There are also potential problems associated with omitted variables and a brief discussion of this issue is included in the limitations section in chapter 8.

All findings are preliminary given the constraints and potential limitations of the analysis provided in the preliminary analysis section above, especially those problems associated with the issue of generalising responses from groups of respondents. However, if these comments are generalisable and evenly distributed then it is possible to suggest that in the case of ED 7, the results provide no evidence that hypotheses 1a or 1b hold. In other words, the findings do not show that arguments arising either from regulated groups nor from certain respondent groups carry significantly greater weight than those from others. Thus, if all arguments are weighted equally in importance\textsuperscript{192} then it is not possible to say that in

\textsuperscript{192} See 7.3 for discussion
this specific instance, there is support for the regulatory capture theory in this context, nor is there support for the political economy of accounting arguments.

There are several reasons why this might be the case, beyond the fact that it is difficult to measure significance when the independent variables in a basic regression model are binary. Firstly, one explanation for finding no support for this hypothesis could be that the lobbying process(es) has(ve) occurred at an earlier stage and the proposal(s) has(ve) already adopted. This proposition cannot be tested because of a lack of evidence from the non-observable phase of the process. However, neither the interview evidence nor survey data collected indicate that there were arguments over and above those produced in the comment letters but this does not mean that for robustness purposes further testing would not be preferable.

Secondly, it might also be that the regulated institutions – in this case banking and insurance – are not concerned with disclosure, but rather with issues such as presentation, recognition and measurement. However, given that many banking and insurance organisations and preparers have lobbied the standard setters, given the importance of commenting on exposure drafts to ensure maximizing the chance of changes and given the importance of disclosure to users of financial statements, then these arguments become less persuasive. Also, many of the issues brought out in the comment letters are reflected by the interview evidence and survey data analysed in chapters 4 and 5.

It is crucial to note that neither do the results say that regulatory capture theory and the political economy of accounting carry no truth – nor is this the conclusion of this study. One can only draw the conclusion that in this scenario there is no evidence for them, and this runs contrary to expectations. The conclusions are further complicated because of the limitations related to rational choice theory. In other words, there is a lack of data regarding those who did not engage in the process and what they would have lobbied for and how they would have gone about that lobbying. Again, this cannot be tested because one cannot know who withheld, the opinions they hold, the strength of those opinions or how their comments would have been interpreted. Therefore this proposition also cannot be tested.
A third problem is that of whether the significance of findings was weighted towards comments that were minor or marginal e.g. correcting spelling mistakes. In response to this point some analysis has been undertaken and the results provided in section 7.5.1 above. This serves to highlight that even those comments which might be adjudged to be ‘tinkering’ or ‘marginal’ are fairly significant. Changes to one word can mean a change to the fundamental requirement e.g. the omission of the word ‘financial’ before ‘assets’ could have a significant knock-on to other standards and to the disclosure that would be produced in response to this. One should also be conscious of weighting comments as discussed in the method above.193 Nevertheless, appendix J contains some robustness tests that aim to mitigate some of the risks associated with this problem.

Another issue is that the wrong explanation is being sought that drives the results. This study mainly focuses on the political aspect as being the driver for both comment letter writing and comment integration. There are many other reasons why letters could be written and why the proposed amendments might not be adjusted for. There is the chance that the comments are not read in the first instance. On balance this seems an unlikely explanation given the quote from the standard setter (interviewee 6; above), the standard setters due process documentation, and findings from similar prior studies. More likely alternative explanations are briefly outlined here. There is the chance that some comment letters are better designed (e.g. rhetorically) and therefore through their internal persuasiveness stand a greater chance of being accepted. There is also the issue that the level and nature of the content might differ. For example, it is noted above that the insurance industry have made comments that focus on the differences between IFRS 4 and IFRS 7 and, hypothetically, if these comments were accepted holistically and IFRS 4 was scoped

---

193 However, as part of this process comments were sub-categorised into those concerning relevance, understandability and fair representation. It was noted that those concerning relevance were normally substantial and were often claiming a lack of relevance to a word, statement, clause, paragraph, requirement or the whole standard. Thus, these comments commonly called for some form of deletion. Those comments categorised as related to understandability tended to be more presentational focused and thus might fall under the suspicion of being marginal. Those classified as being related to fair representation were a mixture of the two – presentational and substantive. Often these comments called for clearer guidance or increased clarification of a point to ensure that the information being presented was a fair representation of position and performance. See appendix J for results.
out then these comments would all register as successful.\textsuperscript{194} This would skew the results and make it appear as though insurance preparers and organisations had significantly greater relative power whereas really it results from happenchance. On a similar note, it might also be the case that one group of comment letter writers are simply more knowledgeable about what is achievable with a comment letter and therefore their comment letters will be seen as more successful (or unsuccessful depending on their gaming strategy) where in reality they might not be achieving what they want. Also on a linked subject, comment letters are said (e.g. Georgiou, 2010) to reflect conversations had at a non-observable phase of the standard setting process. If this is the case then the respondent might be in a position to game their response accordingly e.g. leave out comments which have already been amended and create new ones; or, in a show of their relative strength to clients or peers, include only those comments which they are reasonably sure will be amended for. This list of reasons is far from complete but provides a brief outline of the difficulties faced when analyzing a problem of this nature. Where possible the analysis below attempts to control for these issues but these alternative conclusions must always be regarded as possible until the evidence sufficiently proves that they are not.

The results indicate that Hypothesis 2 does not hold. In fact, the results of the regression analysis suggest that it is disadvantageous for UK-based organisations to make comments (at the 10\% level). However, the results strongly suggest (at the 1\% level) that organisations based outside of Europe and the US should not make suggestions.\textsuperscript{195} This is a somewhat surprising result. One would expect the IASB to listen to all comments equally. With respect to the organisations classified as being from ‘other’ origins, specifically those where English is not the first language, it might be that these are less clear or do not argue as persuasively for change. However this argument seems outdated given the globalization of both world trade and international standard setting collaboration and there is no observable evidence of this.

\textsuperscript{194} The analysis in appendix I seeks to mitigate this risk but it is far from final especially as it only contains comments that were successful and not those that were not.
\textsuperscript{195} There are versions of the model that show international organisations should make comments because they are significantly (at the 10\% level) more successful.
There are other general possible explanations for this finding. These have been outlined above e.g. differing levels of sophistication of respondents in terms of rhetoric, knowledge, content and strategy. In the case of this standard in particular, it is also possible that smaller markets are ignored because financial instruments financial reporting is most important to the most developed markets of the US and the UK. However, this does not explain why comments from the UK are not treated equally (see also appendix J).

In addition there is no immediate evidence to support Hypothesis 3 that predicted that predominantly positive letters would have a greater chance of success when they made arguments for change. The IASB seem to have acted fairly and rationally in this regard and have managed to ignore discourse led persuasion strategies. Again, this might not hold and other explanations should be sought before this conclusion becomes robust. The only rhetorical strategy tested for was the one cited in the prior literature however there are other methods and layers of discourse persuasion.
### Table 31: Correlation coefficients between variables

**Model 1 correlation**

<table>
<thead>
<tr>
<th></th>
<th>Strength of comment</th>
<th>Professional: Accounting</th>
<th>Professional: Banking</th>
<th>Professional: Other</th>
<th>Accounting firm (all)</th>
<th>UK only</th>
<th>Europe (excl UK)</th>
<th>US</th>
<th>Other countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>0.02</td>
<td>0.01</td>
<td>0.01</td>
<td>0.19</td>
<td>0.12</td>
<td>0.12</td>
<td>0.13</td>
<td>0.18</td>
<td>0.11</td>
</tr>
<tr>
<td>Strength of comment</td>
<td>0.26</td>
<td>(0.13)</td>
<td>0.06</td>
<td>0.06</td>
<td>(0.16)</td>
<td>0.20</td>
<td>0.10</td>
<td>0.14</td>
<td>(0.07)</td>
</tr>
<tr>
<td>Professional: Accounting</td>
<td>(0.40)</td>
<td>(0.26)</td>
<td>(0.17)</td>
<td>(0.34)</td>
<td>(0.10)</td>
<td>0.05</td>
<td>(0.17)</td>
<td>0.23</td>
<td></td>
</tr>
<tr>
<td>Professional: Banking</td>
<td>(0.25)</td>
<td>(0.16)</td>
<td>(0.32)</td>
<td>(0.08)</td>
<td>0.16</td>
<td>(0.08)</td>
<td>0.09</td>
<td>0.02</td>
<td></td>
</tr>
<tr>
<td>Professional: Other</td>
<td>(0.10)</td>
<td>(0.21)</td>
<td>(0.01)</td>
<td>(0.08)</td>
<td>0.09</td>
<td>(0.08)</td>
<td>0.24</td>
<td>0.54</td>
<td>(0.11)</td>
</tr>
<tr>
<td>Accounting firm</td>
<td>0.30</td>
<td>(0.05)</td>
<td>0.09</td>
<td>(0.15)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Preparers (all)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK only</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.45)</td>
<td>(0.23)</td>
<td>0.21</td>
<td></td>
</tr>
<tr>
<td>Europe (excl UK)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.45)</td>
<td>(0.41)</td>
<td></td>
<td>(0.21)</td>
</tr>
<tr>
<td>US</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Model 2 correlation**

<table>
<thead>
<tr>
<th></th>
<th>Strength of comment</th>
<th>Professional: Accounting and accounting firms</th>
<th>Professional: Banking and banking preparers</th>
<th>Professional: Insurance and insurance preparers</th>
<th>Prof other and other</th>
<th>UK</th>
<th>Europe (excl UK)</th>
<th>US</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>0.02</td>
<td>(0.02)</td>
<td>0.03</td>
<td>(0.17)</td>
<td>0.16</td>
<td>(0.13)</td>
<td>0.18</td>
<td>0.11</td>
<td>(0.23)</td>
</tr>
<tr>
<td>Strength of comment</td>
<td>0.26</td>
<td>(0.13)</td>
<td>(0.16)</td>
<td>(0.04)</td>
<td>(0.20)</td>
<td>0.10</td>
<td>0.14</td>
<td>(0.07)</td>
<td></td>
</tr>
<tr>
<td>Professional: Accounting and accounting firms</td>
<td>(0.47)</td>
<td>(0.29)</td>
<td>(0.38)</td>
<td>(0.15)</td>
<td>(0.05)</td>
<td>0.05</td>
<td>0.17</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional: Banking and banking preparers</td>
<td>(0.25)</td>
<td>(0.33)</td>
<td>(0.09)</td>
<td>0.19</td>
<td>(0.09)</td>
<td>(0.06)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional: Insurance and insurance preparers</td>
<td>(0.21)</td>
<td>0.27</td>
<td>(0.15)</td>
<td>(0.01)</td>
<td>(0.08)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional: Other and other preparers</td>
<td></td>
<td>0.06</td>
<td>0.01</td>
<td>(0.01)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td></td>
<td>(0.45)</td>
<td>(0.23)</td>
<td>(0.21)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Europe</td>
<td></td>
<td>(0.45)</td>
<td>(0.41)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>US</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.21)</td>
</tr>
</tbody>
</table>
Table 32: Regression results

<table>
<thead>
<tr>
<th></th>
<th>Model 1a</th>
<th>Model 1b</th>
<th>Model 2a</th>
<th>Model 2b</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Coefficient (P-value)</td>
<td>Coefficient (P-value)</td>
<td>Coefficient (P-value)</td>
<td>Coefficient (P-value)</td>
</tr>
<tr>
<td>Strength of comment</td>
<td>-0.0166  (0.4966)</td>
<td>-0.0151  (0.5276)</td>
<td>-0.0098  (0.6911)</td>
<td>-0.0116  (0.6380)</td>
</tr>
<tr>
<td>Professional: Accounting</td>
<td>0.0615   (0.5191)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional: Banking and insurance</td>
<td>-0.0568  (0.5422)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional: Other</td>
<td>0.1768   (0.1246)</td>
<td>0.1186   (0.2900)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounting firms</td>
<td>-0.1961  (0.2036)</td>
<td>-0.2536  (0.1025)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Preparers (all)</td>
<td>-0.0576  (0.5712)</td>
<td>-0.1149  (0.2689)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional: Accounting and accounting firms</td>
<td>0.0193  (0.8321)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional: Banking and banking preparers</td>
<td>0.0083  (0.9278)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional: Insurance &amp; insurance preparers</td>
<td>-0.1137  (0.3404)</td>
<td>-0.1082  (0.3644)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional: Other and other preparers</td>
<td>0.1003  (0.3114)</td>
<td>0.1062  (0.2913)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>-0.1618  (0.0960)</td>
<td>** -0.1596  (0.0998)</td>
<td>-0.1293  (0.2067)</td>
<td>-0.1315  (0.1988)</td>
</tr>
<tr>
<td>US</td>
<td>0.0226   (0.8162)</td>
<td>0.0200   (0.8365)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others (i.e. not Europe or US)</td>
<td>-0.2835  (0.0057)</td>
<td>** -0.2805  (0.0059)</td>
<td>** -0.2249  (0.0327)</td>
<td>** -0.2306  (0.0286)</td>
</tr>
<tr>
<td>Observations</td>
<td>80</td>
<td>80</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>R²</td>
<td>0.1638</td>
<td>0.1633</td>
<td>0.1244</td>
<td>0.1249</td>
</tr>
</tbody>
</table>

* Significant at 10% level; ** Significant at 5% level; *** Significant at 1% level
Model 1a: Excludes the groupings Professional: banking and insurance, Europe and US (including international); Model 1b: Excludes the groupings Professional: accounting, Europe and US (including international); Model 2a: Excludes the groupings Professional: accounting and accounting firms and Europe; Model 2b: Excludes the groupings Professional: banking and banking preparers and Europe.

7.6 Conclusion

From the prior empirical and theoretical lobbying literature, three theories seemed most relevant to investigate for a study related to the relative power of participants in the lobbying process. These were: the theory that regulated groups would form coalitions, produce intertwining arguments which would make them stronger and thus force through more changes (Posner, 1974; Mitnick, 1980; Cortese et al., 2010).
Then there were the arguments related to the political economy of accounting frameworks (Cooper and Sherer, 1984), that states that certain organisations dominate the standard setting process, for example accounting firms or preparers (Weetman et al., 1996), and that they perpetuate their own position of importance. Rational choice theory states that organisations will pursue a pathway of self-interest and will only participate where the costs are outweighed by the (potential) benefits (Homans, 1958, 1961; Blau, 1964; Coleman, 1973; Georgiou, 2004). Following detailed analysis reconciling requested changes to actual changes, the results show no significant evidence to support the arguments put forward by either regulatory capture theory or the political economy of accounting.

This study also investigated the notion that the relative intensity of the comment letter could be beneficial to the chances that a proposed revision will be made. Again, no evidence was found to support this notion. It might be said that the IASB have acted rationally by not showing greater consideration to discourse-based persuasion strategies.

For the first time, this study also explored the question of whether the IASB were more persuaded by lobbyists from certain geographical areas. The idea that comment letter writers from certain places are given more consideration than those from others should not, in theory, hold water. However, the findings suggest that this is precisely the case, and comments arising from the UK and from places outside of the remaining nations in Europe and the US are significantly less successful. It is inappropriate without further evidence to conclude that this is purely a political process though. There is no (reported) evidence of unscrupulous lobbying in this particular process. There are many explanations for the non-acceptance of views from outside the US and Europe including a lack of sophistication in the relative levels of specialist financial instruments (disclosures) knowledge, levels of skill in the employment of rhetorical and discourse persuasiveness, and the potential for gaming e.g. not wanting comments amended; certain comments being given prominence and so forth. An information gap prevents an investigation of these issues.
Those parties who have chosen not to lobby also pose a significant challenge to the results. At this late stage in the process – the exposure draft comment period – the standard setters are asking for comments about specifics, and thus, as Sutton (1984) argued, lobbying is likely to be less productive, and therefore attracts fewer participants. Many will have lobbied privately and many will have been involved in the standard setting process in a discretionary consultative capacity already. This review does not capture this data and without full transparency no study will be able to ensure it fully accounts for the unobservable phase(s) of the process. The fact that users have not participated at all in the ED 7 comment letter process is a genuine issue, both from a research perspective and from the IASB’s perspective. One might even begin to argue that this calls into question whether the standard setting process is satisfactory or whether this key user group believe this particular standard is important.

This study investigated the standard setting process from the perspective of identifying whether certain respondents, groups or affiliations were more powerful than others. Despite finding that comments arising from certain geographical origins were not viewed equally, it is nevertheless reassuring to see that speculations about the relative lobbying strength of key players were not found to be statistically significant. It would appear that the IASB have acted fairly and rationally with regards to the way they have responded to calls for change during the process.
Chapter 8: Conclusions, recommendations and limitations

The key conclusions from each of the four findings chapters, 4 to 7, are presented below alongside some recommendations and limitations. However, it is necessary to show how these studies are connected and to provide an outline of the incremental key contribution made to the current literature of each.

Underpinning the study as a whole is the issue of entities’ compliance with the mandatory financial instruments disclosures reporting requirements. Chapter 4 presents the results from the first full compliance review of these disclosures undertaken in the UK. This study highlights material issues of full, partial and non-compliance and attempts to provide possible rationale for disclosure behaviour. Following this, chapter 5 addresses the question of over compliance. In other words, the study poses two questions: firstly, do firms provide voluntary information in excess of the mandatory disclosure requirements; and secondly, if they do, is it possible, given the restrictions of information asymmetry between those who disclose and those who view the disclosures, to provide possible explanations for these disclosures or this behaviour. Chapter 6 builds on the compliance review, particularly the results presented in chapter 4, by arguing that the level of compliance can be used as a possible proxy for the level of quality. This argument is built upon the underlying belief that the determinants of financial reporting quality are the qualitative characteristics. This supposition rests upon the fact that these qualitative characteristics have been deemed by the international financial reporting community to be the primary features of decision making useful information. This study then attempts to address the issue of which corporate characteristics drive the levels of quality (compliance) and quantity. Chapter 7 asks whether the results of the disclosure review could have been effectively skewed in the favour of certain entities, groups or coalitions before the standard was even published. This question is addressed by testing the relative strength of possible groups of significant influence.

The individual chapters are not only connected by the compliance review but also by the stakeholders’ feedback on IFRS 7 and the standard’s disclosure requirements. The project has analysed and presented results from a self-constructed survey, semi-structured interviews and comment letter analysis. For example, discussions in
all four chapters (4 through 7) are supported by the interview data with the purpose of adding weight to otherwise speculative assertions. This additional data and its analysis ensure that this study forms a contribution to the area of financial instruments disclosures and to disclosure decisions literature as a whole. As discussed in the methodology chapter, many studies focus on a single method – quantitative or qualitative – with a leaning in accounting research towards the former. This does not mean however that many prior studies have not called for direct contact with the key stakeholders to facilitate the justification of otherwise speculative conclusions and to allow an additional level of depth and insight. This study answers those calls.

On a chapter by chapter basis there is also an incremental contribution to the literature. These are as follows:

- Chapter 4 presents the first full compliance review of financial instruments disclosures in the UK under IFRS 7 reporting requirements. The study finds that conclusions from prior work about the failings of financial instruments disclosures are not universal and are not apparent within the sample selected. Previous studies found relatively low levels of compliance whereas this study found high levels. Prior work argued the disclosures were incoherent, overly complex and lacked uniformity whereas this study finds the opposite to be true. Alongside the empirical results, a conceptual framework based upon extant theory is presented that aims at assisting the identification of the rationale for full, partial or non-disclosure dependent upon the information being presented.

- Chapter 5 presents details of over-compliance. This study contributes to the literature by answering calls to identify and analyse specific cases of this form of disclosure behaviour. Theoreticians have argued that voluntary disclosure over and above the mandatory requirements might arise for various reasons (for example, pressure from externalities) but this is the first study to specifically identify examples of over compliance and to discuss them individually. In the main, evidence appears to support arguments associated with legitimacy however there might be other reasons that are hidden as a result of disclosure decisions being private.
• Chapter 6 is principally a determinants of financial instruments disclosures study and, as the underlying data is unique, then this study forms a contribution in this regard. However, the principal contribution of this study lies in the finding that quality (compliance) and quantity (of disclosures) appear to be driven by different factors. Often these two variables produce results that are in direct opposition to each other. Thus the study casts doubt on the applicability of quantity as a proxy for quality.

• Chapter 7 finds that the IASB appear to have acted fairly and rationally in their consideration of comment letters in respect to the proposed financial instruments standard disclosures and do not show favour to specific groups or coalitions. However, the study raises the concern that the IASB have not acted fairly and rationally when dealing with comments from the UK and the rest of the world (classified as not Europe [excluding UK] or the US). The study suggests this may be due to political bias but there may be other reasons including (but not exclusively) the rhetorical strategy employed or the practicality of making the proposed adjustments.

8.1 Mandatory reporting compliance issues and a suggested rationale

8.1.1 Mandatory reporting compliance issues and a suggested rationale: Conclusions

This compliance study provides the first comprehensive review of the financial instruments disclosures for FTSE 100 non-financial IFRS 7 compliant entities for years commencing on or after 1 January 2007. In contrast to prior compliance work (Elmy et al., 1998; Roulstone, 1999; Bhamornsiri and Schroeder, 2004; Jones and Wei, 2004; Lopes and Rodrigues, 2007; Hassan et al., 2008), the findings indicate that the level of disclosures was high and that the IFRS 7 requirements were largely adopted wholesale. There were particular areas where partial or non-compliance was specifically noted, namely in the areas of: derecognition; reclassification; defaults and breaches; unlisted investments accounting practice and policy; and sensitivity analysis.
The observances of partial and non-disclosure map closely to expectations formed on the basis of prior mandatory and voluntary disclosure research. Theories supported by the findings include legitimacy (reputation maintenance and enhancement) and impression management. Equally, where one would predict high levels of compliance and corresponding full disclosure, for example with regards to the hedging or fair value disclosures, the underpinning theoretical explanations derived from prior work held. Consistent with previous research, the argument is put forward that full disclosure and full compliance are typically associated with cost of capital advantages through wealth creation, risk minimisation and reputation preservation (Koonce et al., 2005; 2008).

In addition to the compliance results, it was also found that the disclosures of financial instruments consistently followed an easily recognisable pattern. This is in direct contrast to conclusions from prior studies (Bhamornsiri and Schroeder, 2004). In many cases, the disclosures were captured under one note, as was the original aim set out in ED 7. However, there are occasions where this would be illogical – mainly because of the volume, scope, nature or depth of disclosures – in which case the information was sub-divided between multiple notes. It is common for information in the audited financial statements and notes to the financial statements to be cross-referenced to the unaudited, narrative, front-end section of the annual report (for instance the OFR or Management Commentary). There was scant evidence that cross-referencing to the front-end of the annual report was overly concerning or confusing; neither does the evidence suggest that this created any unnecessary confusion. On the few occasions where there was cross-referencing of this kind, it was found that, with the exception of one company, the information was by and large repetitious of the significant risks arising from financial instruments notes, and did not contain separate information. It was not found that incoherence and lack of uniformity were issues – as has been reported by other studies. However, one could argue strongly that this disclosure is most likely intended only for those, firstly, who are sophisticated users of financial information and secondly, those with a significant amount of time to review it. Although calls for greater levels of disclosure in this area have been made, regulators should be wary of the danger of information overload when revising standards. The interview and survey data suggest that this might be an issue going forward.
Despite disclosure levels being consistently high, evidence was consistently found of non-compliance. This is worrying insomuch as the entities considered by this study are the largest non-financial firms listed in the UK, and they are all audited by the Big Four accounting firms that are commonly perceived to be the elite (McMeeking et al., 2006; Francis, 2004; Francis and Wang, 2008). Therefore, this might flag up concerns about disclosure compliance, as companies become smaller and their auditors become (in theory) less expert and practised. Consistent with this line of thought, in September 2010 the FRC heavily criticised small firms for failing to conduct audits to a satisfactory level.

One area of general weakness in financial reporting disclosure related to the poor preparation and presentation of the sensitivity analysis. As many of the comment letters in relation to ED 7 objected to this disclosure on grounds of the information inappropriately requiring the release of competition sensitive information disclosure, and that the costs of preparation were disproportionately high given the perceived benefits, it always seemed plausible that less than full compliance would be observed. It is proposed that this disclosure should either be revisited and improved by the standard setters, or simply removed. The interviews carried out as part of this overall project mentioned that this information added little value given its lack of timeliness, verifiability and consistency. If Dye’s (1986; 1990) contention is correct, then companies will either disclose this voluntarily or externalities will ask for the information they require. It should be noted however that this does not provide auditors the excuse not to ensure full compliance.

This study makes several contributions to the literature. It should act as an aid to help users of financial information, and specifically stakeholders reviewing financial instruments mandatory disclosures, to understand the adoption and application issues related to IFRS 7. It is also believed that this study could assist standard setters regarding where their future energies should be directed if they are concerned with overall compliance. Preparers might also consider their own disclosures in more detail. Across the reporting community it might also be beneficial to consider a push towards obligatory disclosure committees similar to those
required by Sarbanes Oxley might be desirable within the UK's corporate governance regulations.

8.1.2 Mandatory reporting compliance issues and a suggested rationale:

*Recommendations and limitations*

The empirical findings of this research suggest that compliance with IFRS 7 is high. Although there are observable errors and omissions, these are few, especially in comparison to prior work of similar disclosures from the US, Australia, Portugal and Malaysia. This might be in part due to the visibility of the companies sampled in this study, but also to the sampled entities being audited exclusively by the Big Four. If this study were to be extended or similar studies undertaken, then one would recommend a broader and larger sample for the compliance review. The additional sampled entities would aim to review a wider range of companies' disclosures by looking far beyond the FTSE 100. This would also ensure that auditors other than the Big Four would be tested. A wider sample would also allow a researcher to test other hypotheses, such as whether (non-) compliance was a function of industry specific or cultural factors.

In addition, this study considered only the non-financial firms of the FTSE 100. There is, of course, a sound rationale for the choice to exclude financial firms. However, if one were to extend this study, then financial firms could also be considered as a matter of completeness. If significantly different results were found between financial and non-financial firms, then this would be an important finding.

A further interesting extension to this project would be to extend the time series beyond a one period model. It should be noted that this would create numerous problems because of the changing disclosure requirements, and arguably, a learning curve effect. These problems would be exacerbated if one were to review disclosures during the transition period between IAS 32 and IFRS 7. However, having raised these concerns, a study of this nature might be able to isolate the errors which were due to first year adoption issues, from those which were (are) being consistently made. This would enable the researcher to focus on those areas
of non-compliance specifically, and thus would make the extension of the sample (as discussed above) significantly less time consuming.

Another major contribution that could be made to extend this research would be to consider the economic significance of these findings. This extension goes beyond the value relevance literature, and instead considers the possibility of identifying the economic or financial impact of full, partial or non-compliance. However, it is clear that this would be difficult and problematic, particularly when one is attempting to measure the economic impact of information that is not disclosed.

The primary limitation arises as a result of human error. Content analysis is as much an art as a craft (Weber, 1990) and analysing text, even in a form-oriented approach (Smith and Taffler, 2000), such as that adopted by this study, would mean that exact replication of the review would be difficult to achieve. Even though sensitivity tests have been conducted, it would be naive to presume there are no recording errors.

Another important limitation of research of this type is that explanations for errors and omissions are frequently borne from conjecture. Even well evidenced and balanced rationale to explain omittance (partial or full) or compliance is speculation. The preparers and auditors of the disclosures are the only stakeholders who can fully explain their disclosure choices and strategies.

8.2 An examination of voluntary financial instruments disclosures in excess of mandatory requirements by UK FTSE 100 non-financial firms

8.2.1 An examination of voluntary financial instruments disclosures in excess of mandatory requirements by UK FTSE 100 non-financial firms: Conclusions

The purpose of the project was initially to explore the question of whether firms voluntarily disclose information in excess of a set of mandatory financial reporting requirements. If this were found to be the case then this would necessitate the follow-up question: why are these disclosures being made, given that this is not a costless exercise? The research found that many firms did indeed disclose more information than they were required to by IFRS 7 and it is most likely that this
information, though costly to prepare and often proprietary in nature, formed (forms) part of a broader disclosure strategy. This strategy appears to be linked to a reputation risk management strategy whereby legitimising strategies, positions and performance were important.

The study found that extra disclosures are made to avoid adverse selection (Grossman, 1981; Milgrom, 1981). This is consistent with findings from prior voluntary disclosure work, that hypothesised bad news would be reported where the cost equilibrium shifts in favour of the reporting of the information (Verrecchia, 1983).

This research proposes that there are certain triggers for additional disclosures in excess of the mandated requirements of an accounting standard. A key generator of this additional disclosure of financial instruments information was unexpectedly high losses recognised on financial assets and financial liabilities, classified as fair value through profit or loss. These have, without exception, been explained by firms in greater detail than is mandatorily required. It is possible that these disclosures pre-empt requests from externalities (Dye, 1990). However, if this were to be the case, then one needs to seriously ask whether the annual report would be the appropriate place for these additional legitimacy oriented disclosures or whether a separate information medium, for example a conference call or presentation, would be a more suitable method.

Though there is some evidence of impression management where the information appears to be intended to mislead users of the financial statements, the research findings present the case that the disclosures are more consistent with the legitimacy theory hypothesis. This is consistent with prior studies (Chalmers and Godfrey, 2004; Bebbington et al., 2008; Aerts and Cormier, 2009). A comprehensive and thorough review of the additional information disclosures does show that there are occasions where the information is presented in a way which appears to be intended to mislead the audience – or, at least, a less sophisticated audience. This is somewhat troubling but at the same time puzzling because given the complexity of the disclosures one is forced to consider the question: ‘Who are the less sophisticated users who are looking at this information?’ The answer to this question is one which future researchers might like to consider in greater detail. Another interesting research
question that could be asked is the extent to which financial instruments disclosures adequately portrayed the risks that financial and non-financial entities were (are) exposed to prior and subsequent to the banking crisis. Due to the sheer size of such a project this question is left for further work.

8.2.2 An examination of voluntary financial instruments disclosures in excess of mandatory requirements by UK FTSE 100 non-financial firms: Recommendations and limitations

Limitations exist in terms of both design and method. The research was carried out using a content analysis approach. It has been well documented both here and in prior studies that content analysis has its weaknesses as a research method (Beattie and Thomson, 2007; Krippendorff, 2004; Unerman, 2000; Weber, 1990; Milne and Adler, 1999). These weaknesses stem from the core issue that there is a potential lack of reliability and that the analysis is judgemental. If one considers that content analysis can be broken down to two variants (Smith and Taffler, 2000) – form-oriented analysis and meaning-oriented analysis – then it is worth highlighting that this study employs both variants. The disclosures are reviewed using form-oriented analysis to identify areas of over-compliance, which is often seen as the more reliable of the two variants. Following this, meaning-oriented analysis has been used to interpret the disclosures which are provided in excess of the requirements of IFRS 7. This interpretative approach to analysing disclosures is a highly subjective exercise. However, wherever possible, the findings are evidenced by further information, detail and data so that the results reported are weighted against the balance of most likely outcomes.

A further limitation to the research undertaken is that the sample size is small. A combination of the following four approaches could be adopted by future researchers to extend the work: first, simply extend vertically and build in more companies; second, extend the time horizon to bring in prior and future years; third, identify one (or more) specific industry(-ies) who show the greatest variance from mean in disclosure terms and analyse the voluntary disclosures produced; and finally, expand the search beyond IFRS 7, i.e. review total compliance with disclosure requirements and analyse any additional disclosures produced. Whilst computer technology is not
sophisticated enough to perform this analysis for the researchers, then any of the above approaches will be complex and time consuming.

There are two further limitations with the fact that there were only a relatively small number of companies making additional voluntary disclosures. First, this meant that any statistical tests of significance would be meaningless. Second, ‘scoring’ these voluntary disclosures for quality would be unhelpful.

Having noted these limitations, there are several potentially highly lucrative avenues that future researchers could pursue to build on this work. The voluntary disclosures could be examined in greater detail using more advanced techniques, especially those provided by the linguistics literature.

This research also gives rise to a number of important and previously unanswered questions. However, it seems that there are two fundamental questions that future researchers could explore. These are: ‘Who uses this information?’; and ‘What is the economic significance of this additional information?’ According to the IASB, the mandatory disclosures are meant to add value and though what, when and how much have been queried by academics (such as Schipper, 2007), the question remains relatively unexplored. This might seem churlish or naive; however, as reported in Chapter 6 and further supported by collected but unreported interview and questionnaire data arising from the research conducted, there are serious concerns amongst sophisticated user groups that this information goes beyond their requirements and is most likely, on the whole, simply to be ignored. More worryingly, this group suggested that there are concerns that this information goes beyond the interpretational abilities of analysts and investors. Certainly, exploring the information fully would be too time-consuming for many high pressured users. Preparers echoed these sentiments and stated that they remain uncertain of the contribution that this information makes to valuations or to the over-riding objective of information usefulness. However this latter group assumed that this information would be more likely to be used as an ex-post measure rather than a predictive one, thus echoing Gigler and Hemmer’s (1998) assertion that the annual report provides a mostly confirmatory service.
8.3 The quantity and quality of reporting financial instruments under International Financial Reporting Standard 7 Financial Instruments: Disclosures

8.3.1 The quantity and quality of reporting financial instruments under International Financial Reporting Standard 7 Financial Instruments: Disclosures: Conclusions

This research presents findings from the compliance review undertaken and presented in Chapter 4 as a measure of the quality of reported financial instruments information. In addition, the number of words is proposed and used as the most suitable proxy to measure the quantity of financial instruments disclosure. The measure of quality is grounded in the original premise that the IASB have produced an accounting standard that adheres to their own objectives of requiring information that is useful for decision-making. Also underpinning this measure of quality is the idea that if information that is mandatorily required is not presented, then the disclosure lacks something – and it can be argued that this thing is information quality. This assumption is tested both ex-ante and ex-post by considering survey and interview data from comment letter writers, analysts and preparers. The assumption of quality is also tested through a review of the comment letters (which is further considered in Chapter 7).

There is a growing literature related to the measure of the quality of information. These measures are varied, and include using quantity as a proxy for quality, external surveys, self-constructed quality metrics and indexes. As noted by other commentators such as Healy and Palepu (2001), these suffer from inherent weaknesses. Quantity simply appears to be an inappropriate proxy for quality, at least in the setting of IFRS 7, given that more information does not necessarily mean higher quality information (studies such as Skinner’s [1994] make arguments about bad news promoting more disclosure). Surveys might carry the bias of the surveyor and when using a third party externally administered survey, a researcher is forced to assume reliability in application and consistency in approach. Finally, those studies that set about constructing an index to measure quality are always facing an uphill struggle, given the inherent complexity of defining a nebulous concept of this type. In addition, these quality modelling studies have been found to be unworkable in practice on a large scale or for periods greater than one year.
As reported in Chapter 4, the results of the compliance review showed a high level of disclosure for the IFRS 7 compliant FTSE 100 non-financial firms for the year beginning on or after 1 January 2007. The compliance percentages ranged from 69% through to 100%, with an average of 94%. The quantity of words varied from approximately 1,000 words to 8,000 words, dependent upon the level of usage of financial instruments.

The comment letter review showed the responses to be predominantly positive, with 70 of the 106 letters (66%) showing support to the full adoption of the disclosure standard. The comment letters were further examined for theoretical arguments, outcome oriented proposals and other concerns. One would have expected these to be broadly negative given the nature of comment letter writing; however, this was not found to be entirely the case. Theoretical arguments were captured using a content analysis approach in terms of the qualitative characteristics. The views expressed showed: 45% of letters with comments related to relevance were positive; 52% stated that the disclosures would ensure greater fair representation; 63% thought IFRS 7 would lead to an improvement in comparability; 30% felt that understandability would be enhanced; and 7% thought verifiability would be improved. This is the first study to report results of this type, and therefore it is impossible to compare responses to other exposure drafts; however, on the whole, these appear to be broadly supportive.

The survey asked respondents to express their views on whether the quantitative and qualitative disclosures in IFRS 7 improved the information usefulness of disclosures in the annual report. Consistent with the comment letter review, the results of the survey showed a largely positive response to the disclosure requirements (with the exception of timeliness and verifiability). There was general agreement that IFRS 7 does capture the key qualitative characteristics, and therefore does provide useful information. As with the comment letter results, a final judgement is subjective as to whether these results are positive and supportive, and this is exacerbated by the fact there is no comparison study.

Though the results are mixed and comments from interviewees, survey respondents and comment letter writers offer some negative comments, in general the analysis
shows that there is general support for the Standard. Many of the comment letters which were negative, carried proposals which were amended by the time of issue of IFRS 7. The survey showed verifiability and timeliness to be issues; however, this problem exists for financial reporting as a whole and not solely financial instruments reporting. Therefore if one believes that the qualitative characteristics capture quality, then this general support from key stakeholder groups reassures us that compliance with the reporting requirements of IFRS 7 can act as a suitable proxy for quality in this, and potentially any, study of mandatory financial reporting.

Having established that compliance is a suitable proxy for quality and that word count acts as a suitable proxy for quantity, these were substituted as dependent variables to test the determinants of disclosure quality and quantity. In the case of quantity, the findings showed that lower levels of managerial ownership and a higher level of news stories versus analysts following were statistically significant. In terms of quality the results indicated that higher visibility in the form of news stories versus analysts following, a share issue during the year and a higher value of derivative assets were of importance. As will be discussed in the limitations and recommendations section below, it is possible that if the sample had included smaller firms the study would show similar results to prior determinants studies i.e. significance to size, Big Four auditor and listing status. However, because these firms are at a critical mass, are all cross-listed and all audited by the Big Four, then these hypotheses were rendered redundant.

These findings are interesting; however, what overshadows these determinants results are the directional findings of the regression analysis. In many cases the direction of variables to quantity and quality move in opposite directions to each other and where the independent variables show statistical significance to quantity this does not necessitate statistical significance to quality. It would not be appropriate or possible at this stage to go so far as to suggest that all prior studies which have used quantity as a proxy for quality are wrong. However, one might urge future researchers who are using firms’ annual reports as primary evidence, to consider measures of quality (whether compliance or otherwise) rather than assuming that quantity is an appropriate proxy for quality.
These results are subject to limitations in the model, specifically the issue of omitted variables. The importance of correlated omitted variable(s) lies in the fact that as soon as the connection between omitted variable bias and control variables is gone, the main justification for using control variables is lost (Clarke, 2005). The mathematics of regression analysis do not fully support the logic of control variables previously ignored. Including more variables in a regression, even relevant ones, might, but does not necessarily, make the regression results more accurate (Maddala, 2001).

Econometricians therefore urge caution with regards to possible omitted variables. It is critically important to note the potential bias, consider its size and the effects on results. It is also worth stating that all of the known 'remedies' are fraught with difficulties. One option, to re-specify the model in its entirety, may eliminate the bias but is very costly to do so. There are well known problems associated with adding alternative or additional control variables. Even limited levels of measurement error in control variables are magnified as more variables are added to an equation in an attempt to control for other possible sources of bias. Griliches (1977, 12) argues we may "kill the patient in our attempts to cure what may have been a rather minor disease originally."

As has been stated clearly in the past by others, discerning the effect of one omitted variable is difficult, and discerning the effect of including a subset of relevant omitted variables is nearly impossible (e.g. Clarke, 2005). It is important to note that all of the approaches proposed to deal with omitted variables are based on the assumption that larger specifications are desirable. However, most techniques are designed explicitly to guard against such specifications. Some statisticians go even further arguing that regression equations based on a few variables are simply more accurate than regression equations based on many variables (Breiman 1992). A caveat of this paper is that whilst it is possible to signal the potential problems and attempt to deal with the bias it is impossible for this (or indeed many other studies) to feel entirely confident that the specified model is free from the curse of the correlated omitted variables.
8.3.2 The quantity and quality of reporting financial instruments under International Financial Reporting Standard 7 Financial Instruments: Disclosures: Recommendations and limitations

This is a wide-ranging study and is, in many ways, the first of its type. Therefore, there are bound to be a number of limitations, and equally recommendations, for further study. It is important to start with the definitions of quality and quantity which are at the centre of the study. There are, of course, other measures of quality which one can use. Robustness checks to test the determinants of quality proved difficult and ultimately lacked integrity. It would have been possible to apply Berretta and Bozzolan’s (2004) quality measurement metric to the financial instruments disclosures; however, the results would be meaningless and would not capture the nature of the information appropriately. The measure was designed to be used on narrative risk reporting of a more simplistic nature than that disclosed by firms in these notes. It has also not been possible to run robustness tests on quality by using the World Bank disclosures survey, the S&P disclosure transparency survey or the AIMR survey as a proxy for quality, as none of them hold data on enough of the companies in the sample to make for a meaningful comparison.

A robustness test that has been run with regards to the quality measure was to make the compliance scores binary. In other words, instead of using a continuous dependent variable the percentage compliance was replaced by ‘1’ or ‘0’. It should be noted that ‘0’ should really be applied to all companies who score less than 100%, as this signifies less than full compliance and therefore a breach in quality. However, this would leave less than 10 companies with a dependent variable of ‘1’ and thus the tests would have been redundant. Therefore, setting the robustness limit at 95% is arbitrary and is effectively as random as cutting a deck of cards to place a marker. Robustness tests were run on quantity using pages and lines as measures, and the results were in line with those produced when using words. It was not possible to use sentences because of the amount of quantitative information, and because sentences in mandatory disclosures do not operate in the same way grammatically or in terms of function as those of everyday discourse.
As has been discussed above in Sections 8.1.2 and 8.2.2, there are the joint issues of this being a small sample study and also a one period measure. However, it would appear that all themes, codes and issues are covered in the sample and that any changes to the required disclosures over time would skew the compliance (checklist and) review. Also, as is almost always inevitable with all mandatory disclosures, the output will become standardised over time and most likely standardised between auditors as the learning curve levels out. Nevertheless, if this study were to be extended then one should recommend that future research considered extending the sample size and time period.

There are also certain unexplored endogenous and exogenous issues. Probably most important is the ‘quality’ of the accounting information. In other words, whether on the one hand the overall performance and positions of the firm have been exposed to excessively conservative accounting or earnings smoothing activities. On the other hand this study has also not investigated issues of earnings persistence or value relevance. All of which have been shown to impact on a firm’s discretionary information content.

Other potential problems are associated with the use of content analysis as discussed above. In this instance there are two additional problems associated with measuring quantity. Both of these are linked to the fact that financial instruments forms such a broad category, encompassing assets ranging from trade receivables through to derivatives held for trading. First, one has to be sure that they have counted all the relevant words of mandatory disclosures related to financial instruments as they are spread throughout the annual report. Second, it could be queried whether equal weighting should be placed on the word count of one asset to another. In other words, one might question whether the derivatives word count is more important than the trade receivables word count. Every word has been considered as equal because this is a measure of quantity, and to attempt to maintain levels of consistency and reproducibility in the design (Krippendorff, 2004) this concept is not one that should be weighted.

A further limitation is a lack of comparability with other studies. Though Toms (2002) and Hasseldine et al. (2005) have studied quality and quantity in terms of reputation
and narrative information, they have gone about their research and analysis in a different way. Also, there is a lack of comparability regarding both the comment letter review and the survey data. There is no other research that has categorised theoretical comments as positive or negative and no other study has asked users their attitudes towards disclosures. Therefore, whilst this study has concluded that stakeholders have a broadly positive attitude towards the Standard and whether it captures the qualitative characteristics, this is open to debate.

Similar to the other chapters in this study, other interesting extensions would include considering compliance across the annual report overall, and a larger sample size including smaller entities and also foreign entities. However, measuring compliance and quantity is a time consuming process and until computer software improves then this is destined to be an area where small sample sizes dominate the literature. In addition it is worth noting that a small sample size does have the added benefit over a larger one of allowing the researcher to consider exceptions, points of interest, differences and outliers more closely.

8.4 Comment integration and the relative effectiveness of constituents’ lobbying success

8.4.1 Comment integration and the relative effectiveness of constituents’ lobbying success: Conclusions

The purpose of this study was to further test the hypothesis that IFRS 7 captured the qualitative characteristics that contribute to useful information. This would be brought into question if it was found that certain constituents could disproportionately influence the standard setters to adjust the Standard in their favour. Prior studies have argued that this is theoretically probable whilst others have found empirical evidence of this behaviour.

The lobbying process is often described as a political as well as a technical process (Sutton, 1984; Zeff, 2002; Whittington, 2005; Durocher et al., 2007). Within this framework emerge two key theories which have been tested as part of this study: regulatory capture theory (Posner, 1974; Mitnick, 1980; Cortese et al., 2010) and the
political economy of accounting framework (Cooper and Sherer, 1984). However, a limiting factor is that rational choice theory states that organisations will pursue a pathway of self-interest and will only participate in a process where the costs are outweighed by the (potential) benefits (Homans, 1958, 1961; Blau, 1964; Coleman, 1973; Georgiou, 2004), and thus the comment letters are unlikely to capture all possible comments from all stakeholders.

The results indicate that neither regulatory capture theory nor the political economy of accounting theory hold. A detailed analysis was performed whereby proposed outcome oriented adjustments were reconciled to actual changes to the final Standard. The descriptive statistics show that comments appear to have been taken on merit with no party, group, or geographical region dominating the process. The regression results show no significance that would indicate support to the arguments put forward by either regulatory capture theory or the political economy of accounting.

This research then proceeded to explore what is often considered an important discourse strategy in the comment letter writing process. It is thought that if a respondent writes a broadly positive letter and then asks for adjustments to be made, then these requested amendments are more likely to be successful. No evidence of this was found. Thus, it would appear fair to say that the IASB act fairly and rationally in the face of pressure groups and discourse strategies.

This study extended prior lobbying research by asking whether the standard setters considered proposals from certain geographical areas over lobbying from others. The internationalisation of the financial reporting community means that due consideration should be equally given to comments and respondents from all over the globe. Many feel however, that certain lobbyists are more likely to be heard. The findings suggest that unfortunately this appears to be the case, and comments arising from the UK and from places outside of the Europe and the US are significantly less successful. Though there might be reasons for this finding, such as the US being more advanced in applying financial instruments reporting standards than other areas of the world because of the developments made since SFAS 133,
this is not an entirely satisfactory result for establishing the fairness of the standard setting process.

This study was originally designed to fit in with the broader study of the fairness of the standard setting process and whether certain lobbyists, groups or affiliations were more powerful than any of the others. Despite finding that comments arising from certain geographical origins were not viewed equally, it is nevertheless reassuring to see that speculations about the relative lobbying strength of key players were not found to be statistically significant in the case of the financial instruments disclosures standard. It would appear that the IASB have acted fairly and rationally with regards to the way they have responded to calls from alignments and coalitions for change during the process.

8.4.2 Comment integration and the relative effectiveness of constituents lobbying success: Recommendations and limitations

This study suffers some limitations both in terms of design and method. The key methodological issues arise because of the standard content analysis reliability issues (Krippendorff, 2004) and the inherent subjectivity in the coding process (Weber, 1990). These are mitigated by getting another, independent coder to review the process and perform a sensitivity test but, as with all content analysis projects, replicating a study of this type and generating exactly the same results would be almost impossible.

As with all prior work where comment letters are analysed to observe lobbying behaviour, this study suffers from design issues. First, comment letters might not capture the genuine opinions and attitudes of respondents or all those whom the respondent is responding on behalf of. Second, by reviewing comments which focus solely on one issue, or in this case one Exposure Draft, one ignores the possibility that there may be a broader lobbying strategy at play which would be unobservable at this level. Third, this study focuses on those who have responded to the proposals and therefore, by default, does not concern itself with those who have not. Fourth, this study does not attempt to identify or investigate other forms of lobbying beyond the comment letters. Finally, all arguments are considered equal in weight. This last
issue is potentially significant and is commonly overlooked in studies of this type. A typical argument to dispose of an entire paragraph might be successful whereas a proposed phraseology amendment might be rejected, and yet this is not factored into the analysis.

An innovative and compelling approach for ranking comment importance was developed by McEnroe (1993). He attempted to quality score comments by asking 34 experts to judge the comments on a nine-point Likert scale. There are a number of problems when it comes to replicating this analysis. The first issue is one of practicality – and particularly finding 34 neutral and independent judges to undertake the lengthy coding exercise. The second is that McEnroe summarised the requested amendments into six proposed changes. This study identifies 221 proposed adjustments and classifying each for quality would be subjective, time consuming and potentially devaluing. McEnroe found the reliability of coding between judges to be high (alpha 0.93). However, it is difficult to know how to read this statistic given that all comments fell between the range 3 and 5. In addition it is necessary to consider the logistics and applicability of a study that opted for a weighting exercise. An investigation that attempted to weight arguments would firstly need to establish how the respondents rank their own arguments and, given the inherent bias that would be present in any constituent’s response, this would be incoherent and would fundamentally lack integrity. For instance, using the example above, it might be that a minor change of wording would be more important to the respondent than the deletion of an entire paragraph. Therefore, the arguments remain unweighted for this study.

In terms of design, this study shares the limitations of prior work in this area. As with many lobbying studies, this piece of research considers only one exposure draft. This ignores the possibility that lobbyists might have an overarching lobbying strategy that would be unobservable when considering one letter in isolation. In addition, this study has only considered the comment letter writing process and other observable and non-observable lobbying processes. It is possible that representatives from different countries do their most successful lobbying at other stages, and therefore this would call into question the results of the regression analysis above.
In addition, as mentioned above, the lobbying section of this study is potentially flawed from the outset because of the arguments outlined by rational choice theory. There are those who simply choose not to lobby because the costs outweigh the benefits. When the standard setting process is at this late stage then fewer lobbyists will be attracted because the standard setters are asking for comments on specific issues and lobbying is less likely to be successful (Sutton, 1984).

Certain data is unavailable and therefore presents the analysis of three lines of enquiry which have previously attracted researchers’ attention. Prior work has shown that it is less common for users of financial information to lobby as opposed to accounting firms, preparers and their representatives (Tandy and Wilburn, 1992; Weetman et al., 1996; Durocher et al., 2007; Hochberg et al., 2009). Within the sample only one comment letter has not been classified into the categories of preparer, representative or accounting firm, and one cannot be sure that even this letter was from a user.\textsuperscript{196} The second hypothesis that cannot be commented upon because of data restrictions lies within the discourse of The Logic of Collective Action (Olson, 1971). This work argues that lobbying action will be proportional to lobbyist’s size. Prior studies have found this to be true for lobbying entities as a whole (Briloff, 1986; Chatov, 1986; Francis, 1987) and for audit firms specifically (Puro, 1984). Brown and Feroz (1992) found that net sales and number of segments (as proxies for size) were statistically significant determinants of the influence carried by participants in the comment letter writing process, whilst the level of tax subsidy was not. However, replicating a review of these hypotheses would be redundant given the high number of responses from professional bodies and the low level of response from individual participants (i.e. the problem of non-response bias). The third hypothesis which cannot be tested relates to the argument that the standard setters are not absolutely free from bias, because those who fund have a relatively greater influence. In recent times the professional bodies have been making contributions on behalf of their funding parties. This creates a dual problem: first, issues related to identifying who are the funders of professional bodies from non-funders; and second, the difficulty of examining those professional body funders who

\textsuperscript{196} Given the nature of the comments it is more likely it is not, but has been classified as ‘other’.
have raised concerns about the proposals and had them voiced through the professional body, raised concerns individually, who have not raised concerns or do not share the concerns which have been raised.\textsuperscript{197}

If one wished to extend this research, then the most potentially lucrative area for further examination would be to investigate the entire standard setting lobbying process from beginning to end, including both the observable and non-observable, direct and indirect processes and strategies. Obviously this would be extremely difficult and time consuming. It would also not be free from subjectivity as to measuring the success of lobbying arguments, and would cause conceptual difficulties when trying to weight each successful activity. For example, would a successful comment at the start of the process be a more important change to the standard than one at the end of the process? Also, this would suffer from the limitation that the lobbying process is being examined for only one standard or issue and therefore if this were to be truly extended to capture the relative strength of lobbying and lobbyists, then one would need to consider looking at multiple Standards and issues.

8.5 Summary

In summary, this project has provided evidence that contributes to the audit and financial reporting literature. The compliance review provides the bridge between the various areas of investigation and ultimately underpins the proposed definition of quality. This definition is subsequently tested – both \textit{ex-ante} and \textit{ex-post} for both robustness and integrity. Survey and interview data suggests that a general level of satisfaction exists amongst key stakeholders related to the IFRS 7 reporting requirements, thus reinforcing the argument that compliance is an appropriate proxy for quality in this environment. The investigation concluded by showing that the IASB appear to act fairly and rationally when reviewing and amending for respondents comments. Thus, the integrity, credibility and hence quality of the Standard remain relatively unchallenged. This study also highlights that, in this area of financial

\textsuperscript{197} See also section 8.3.2 for brief discussion of the omitted variables problem.
reporting specifically, disclosure quantity should be used with caution as a proxy for disclosure quality.
References


AICPA (1994), *Improving business reporting—A customer focus: Meeting the information needs of investors and creditors, comprehensive report of the special committee on financial reporting (the Jenkins report)*, New York, NY: American Institute of Certified Public Accountants.


Greenwich, Conn.: JAI Press.
Campbell, D., Craven, B. and Shrives, P. (2003), Voluntary social reporting in three
Canadian Institute of Chartered Accountants (1991), *Information to be included in the annual report to shareholders*. Toronto, Ontario: Canadian Institute of Chartered Accountants.
Cerf, A.R. (1961), *Corporate Reporting and Investment Decisions*, University of California, Berkley.


constituents captured the setting of IFRS 6; An accounting standard for the extractive industries, Accounting Forum, Vol. 33, No. 1, pp. 27–37.


Dhanani, A. (2003), Foreign exchange risk management: a case in the mining
133, The Treasurer (November), pp. 35–38.
Vol. 40, No. 4, pp. 1071–1094.
Diamond, D. and Verrecchia, R. (1991), Disclosure, Liquidity and the Cost of Capital,
Dierickx, I. and Cool, K. (1989), Asset stock accumulation and sustainability of
Dobler, M. (2008), Incentives for risk reporting — A discretionary disclosure and
184-206.
practice: A preliminary test of a general model of international accounting
Dowling G.R. (2001), Creating Corporate Reputations, Oxford University Press,
Oxford.
Dowling, J. and Pfeffer, G. (1975), Organizational Legitimacy: Social Values and
Duangploy, O. and Helmi, D. (2000), Foreign currency hedge accounting: multi-
15, No. 5, pp. 232-246.
empirical analysis with Swiss data, Journal of International Financial Management
and Accounting, Vol. 9, No. 3, pp. 216–245.
Dunne, T., Helliar, C., Power, D., Mallin, C., Ow-Yong, K. and Moir, L. (2004), The
introduction of derivatives reporting in the UK: a content analysis of FRS 13
Durkheim,
New York, Free Press.


Essaides, N. (1999), FAS 133 – the good, the bad and the complex, *The Treasurer* (September), pp. 61–63.


International Accounting Standards Committee (released for discussion April 1987), Exposure Draft 29 *Disclosures in Financial Statements of Banks*.


Financial Reporting Council (2009), *Louder than words: Principles and actions for making annual reports less complex and more relevant*, available at www.FRC.org.uk

Financial Services Authority (March 2009), *The Turner Review; A regulatory response to the global banking crisis*, Financial Services Authority.


Fishman, M. J. and Hagerty, K. M. (2003), Mandatory Versus Voluntary Disclosure in Markets with Informed and Uninformed Customers, *Journal of law economics and


Frisch, R. (1934). *Statistical Confluence Analysis by Means of Complete Regression Systems*, Oslo University, Institute of Economics, publication no. 5.


Institute of Chartered Accountants in Scotland and the New Zealand Institute of Chartered Accountants (2011), Losing the excess baggage – reducing disclosures in financial statements to what’s important, available at www.icas.org.uk.

International Accounting Standards Board (effective 1990), International Accounting Standard 30, Disclosures in Financial Statements of Banks and Similar Financial Institutions.

International Accounting Standards Board (December 2010), Exposure Draft: Hedge Accounting, London.
International Accounting Standards Board (December 2010), *Snapshot: Hedge Accounting*, London.
International Accounting Standards Board (December 2010), *Practice Statement: Management Commentary*, London.
International Accounting Standards Board (May 2011), *Who we are and what we do*, London.
International Accounting Standards Board (October 2010), *How we consult*, London.
International Accounting Standards Committee (released for discussion September 1991), Exposure Draft E40 *Financial Instruments*.
International Accounting Standards Committee Foundation (2008; updated December 2010), *Due process handbook for the IASB*, Available at www.iasb.org.
International Accounting Standards Committee Foundation (2003), *International Accounting Standards Committee Foundation Constitution*, Available at www.IASB.org (to be renamed IFRS Foundation Constitution following approval in March 2010).


Joseph, N.L. (2000), The choice of hedging techniques and the characteristics of UK


Louis, J.C. (June 1997), Commodity users struggle with disclosure, Derivativesstrategy.com, Available at: www.derivativesstrategy.com/magazine/archive/1997/0697shrt.asp


Mears, W. (2009), International accounting standards: only fools rush in: G20 leaders were too quick to rip into accountancy rule, Available at: http://www.accountancyage.com/accountancyage/comment/2240902/international-accounting


Milne, M.J. and Adler, R.W. (1999), Exploring the reliability of social and environmental disclosures content analysis, Accounting, Auditing and Accountability


Economics, Vol. 5, No. 2, pp. 147–175.
Osterland, A. (2001), Decoding intangibles, CFO, Vol. 17, No. 4, pp. 56–62
Oxford English Dictionary (2011), Available at: http://oxforddictionaries.com


Salter, N. and Dudley-Williams, L., on behalf of Salter Baxter (2008), *Sustainability Gets Tough*, Available at: http://www.salterbaxter-rethinktank.com/directions


Condition and Results of Operations; Certain Investment Company Disclosures, Available at: http://www.sec.gov/rules/interp/33-6835.htm

SEC Advisory Committee on improvements to financial reporting (2008), Available at: http://www.sec.gov/about/offices/oca/acifr/acifr-ddm-011108.pdf


Sikka, P. (May 1992), The politics of political contributions, Certified Accountant, pp. 46–47.


Reporting Standards, Available at:


Stewart, H. And Clark, A. (2011), Greece’s islands will not be used as collateral, warns prime minister, The Observer (15 May 2011), London. Available at: www.guardian.co.uk

Stigler, G.J. (1964), Public Regulation of the Securities Markets. Journal of Business,


Wallace, R. S. O., Naser, K. and Mora, A. (1994), The relationship between the


Appendix A
Summary of relevant data

Company name

Year
end

ANGLO AMERICAN
AMEC
ANTOFAGASTA
ASTRAZENECA
BAE SYSTEMS
BRIT AMER TOBACCO
BRITISH AIRWAYS
BG GROUP
BRITISH ENERGY
BRIT LAND CO
BUNZL
BP
BT GROUP
CADBURY ADR
CENTRICA
CAIRN ENERGY
COBHAM
CAPITA GRP
CARPHONE WAREHOUSE
DIAGEO
EURASIAN NATURAL
ENTERPRISE INNS
FIRSTGROUP
G4S
GLAXOSMITHKLINE
HAMMERSON
HOME RETAIL GROUP
INTERCONT HOTELS
INTERNATIONAL POWER
ITV
JOHNSON MATTHEY PLC
KAZAKHMYS
KINGFISHER
LAND SEC
LIBERTY INT
MARKS & SPENCER
MORRISON SUPERMKTS
NATIONAL GRID
NEXT
PERSIMMON PLC
PEARSON
RECKITT BENCK GRP
ROYAL DUTCH SHELL
REED ELSEVIER
REXAM
RIO TINTO

31.12.07
31.12.07
31.12.07
31.12.07
31.12.07
31.12.07
31.03.08
31.12.07
31.03.08
31.03.08
31.12.07
31.12.07
31.03.08
31.12.07
31.12.07
31.12.07
31.12.07
31.12.07
29.03.08
30.06.07
31.12.07
30.09.07
31.03.08
31.12.07
31.12.07
31.12.07
01.03.08
31.12.07
31.12.07
31.12.07
31.03.08
31.12.07
02.02.08
31.03.08
31.12.07
29.03.08
03.02.08
31.03.08
26.01.08
31.12.07
31.12.07
31.12.07
31.12.07
31.12.07
31.12.07
31.12.07

Compliance
percentage

Derivative
assets (Current
Year) [Note 1]

93.8%
81.4%
90.0%
94.7%
91.5%
98.8%
97.3%
97.6%
91.9%
90.4%
95.1%
95.7%
98.8%
88.7%
98.9%
93.9%
100.0%
94.7%
80.6%
91.5%
93.5%
94.0%
97.1%
87.5%
97.5%
90.6%
98.5%
92.9%
100.0%
96.1%
91.0%
93.5%
89.0%
87.3%
86.4%
88.2%
98.5%
97.8%
100.0%
98.6%
97.2%
100.0%
85.3%
100.0%
96.1%
98.8%

535.0
3.1
1.9
86.0
1,245.0
235.0
358.0
867.0
53.0
17.0
12.8
10,062.0
387.0
46.0
986.0
2,479.0
11.9
6.7
0.0
130.0
0.0
8.0
123.5
17.4
476.0
0.0
4.3
0.0
268.0
36.0
18.6
0.0
71.0
4.3
25.4
36.6
43.0
1,526.0
13.1
0.0
51.0
0.0
20,005.0
210.0
193.0
653.0

Derivative
assets (Prior
Year)
329.0
9.0
7.3
72.0
1,529.0
200.0
86.0
848.0
105.0
88.0
5.5
13,398.0
52.0
51.0
777.0
0.0
15.6
0.0
0.0
64.0
0.0
2.0
36.0
8.6
193.0
0.0
0.0
4.0
281.0
4.0
3.2
0.0
39.0
14.6
21.0
2.4
19.0
657.0
3.4
0.0
86.0
0.0
20,264.0
219.0
148.0
555.0

Derivative
liabilities
(Current Year)
[Note 1]
586.0
5.3
1.4
0.0
402.0
274.0
90.0
1,170.0
142.0
31.0
1.5
11,407.0
1,072.0
22.0
1,415.0
0.0
4.1
19.1
3.7
116.0
70.0
12.0
64.7
21.8
270.0
13.2
2.8
2.0
834.0
10.0
26.0
0.0
62.0
10.7
97.8
35.1
0.0
433.0
67.3
68.0
16.0
6.0
20,637.0
22.0
37.0
1,325.0

Derivative
liabilities (Prior
Year)
520.0
1.9
0.0
0.0
817.0
113.0
24.0
831.0
89.0
19.0
0.7
13,627.0
1,310.0
35.0
1,957.0
9,694.0
4.3
6.4
0.3
105.0
0.0
22.0
9.3
1.7
100.0
9.8
2.2
0.0
430.0
31.0
13.0
0.0
51.0
0.0
133.5
8.5
1.0
419.0
42.8
101.5
19.0
2.0
20,381.0
9.0
14.0
426.0

Cash flow
gains/ (losses)
to equity
(Current Year)
(286.0)
1.8
(6.9)
(21.0)
41.0
15.0
119.0
(121.0)
(102.0)
(73.0)
(1.1)
155.0
446.0
n/a
169.0
n/a
0.9
5.6
(63.6)
28.0
(17.0)
6.0
33.2
(7.0)
(6.0)
n/a
(17.7)
(1.0)
(111.0)
5.0
(12.2)
0.0
(6.0)
6.7
0.0
(33.5)
7.0
(32.0)
3.4
11.9
n/a
(5.0)
(116.0)
3.0
(34.0)
(424.0)

Cash flow
gains/ (losses)
to equity (Prior
Year)
(502.0)
12.5
0.0
0.0
221.0
13.0
(4.0)
103.0
46.0
114.0
(0.3)
413.0
(201.0)
n/a
(645.0)
n/a
1.3
0.0
(0.2)
39.0
0.0
0.0
22.8
1.1
(5.0)
n/a
(27.3)
1.0
167.0
0.0
3.1
0.0
(9.0)
18.5
0.0
(7.4)
(1.0)
47.0
(34.7)
(7.0)
n/a
0.0
143.0
54.0
32.0
(378.0)

Net Fair value
hedge gains /
(losses)
(Current Year)
12.0
n/a
0.0
0.0
0.0
12.0
n/a
(3.0)
n/a
0.0
0.0
7.0
0.0
n/a
(1.0)
n/a
4.3
0.0
n/a
3.0
0.0
(19.0)
0.0
0.2
2.0
n/a
(0.9)
1.0
n/a
n/a
(0.6)
0.0
5.0
(219.0)
n/a
n/a
0.0
1.0
(1.6)
0.0
(1.0)
0.0
(201.0)
(2.0)
1.0
1.0

Net Fair value
hedge gains /
(losses) (Prior
Year)
2.0
n/a
0.0
0.3
0.3
72.0
n/a
16.0
n/a
0.0
0.0
0.0
0.0
n/a
2.0
n/a
(0.6)
0.0
n/a
(3.0)
0.0
40.0
0.0
0.0
(3.0)
n/a
(0.1)
5.0
n/a
n/a
0.3
0.0
4.0
15.4
n/a
n/a
0.0
18.0
0.1
0.0
0.0
0.0
0.0
0.0
0.0
0.0

Fair value
derivative gains
/ (losses)
(Current Year)

Fair value
derivative gains
/ (losses) (Prior
Year)

0.0
0.0
0.0
30.0
58.0
(181.0)
4.0
(1.0)
0.0
0.0
0.0
7.0
41.0
(14.0)
(65.0)
3,254.0
(0.1)
1.2
0.0
0.0
46.0
3.0
0.0
0.0
(42.0)
3.8
0.0
0.0
16.0
14.0
0.5
0.0
0.0
0.0
25.0
0.0
(7.0)
18.0
0.0
0.0
(3.0)
0.0
0.0
7.0
(3.0)
57.0

0.0
0.0
0.3
11.0
87.0
144.0
2.0
7.0
0.0
0.0
0.0
(608.0)
4.0
19.0
17.0
9,694.0
0.0
0.0
0.0
12.0
0.0
0.0
0.0
0.0
(10.0)
16.1
0.0
0.0
26.0
(31.0)
0.1
0.0
0.0
0.0
163.5
0.0
(12.0)
(114.0)
0.0
0.0
(9.0)
0.0
0.0
4.0
7.0
35.0

Page 377


<table>
<thead>
<tr>
<th>Company</th>
<th>Date</th>
<th>Value 1</th>
<th>Value 2</th>
<th>Value 3</th>
<th>Value 4</th>
<th>Value 5</th>
<th>Value 6</th>
<th>Value 7</th>
<th>Value 8</th>
<th>Value 9</th>
<th>Value 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROLLS-ROYCE GROUP</td>
<td>31.12.07</td>
<td>90.9%</td>
<td>314.0</td>
<td>644.0</td>
<td>57.0</td>
<td>36.0</td>
<td>(149.0)</td>
<td>(284.0)</td>
<td>(6.0)</td>
<td>(26.0)</td>
<td>215.0</td>
</tr>
<tr>
<td>SABMILLER</td>
<td>31.03.08</td>
<td>100.0%</td>
<td>253.0</td>
<td>40.0</td>
<td>531.0</td>
<td>209.0</td>
<td>(225.0)</td>
<td>(2.0)</td>
<td>3.0</td>
<td>2.0</td>
<td>(14.0)</td>
</tr>
<tr>
<td>SAINSBURY</td>
<td>22.03.08</td>
<td>98.8%</td>
<td>4.0</td>
<td>0.0</td>
<td>24.0</td>
<td>45.0</td>
<td>(55.0)</td>
<td>0.0</td>
<td>(4.0)</td>
<td>8.0</td>
<td>0.0</td>
</tr>
<tr>
<td>SHIRE</td>
<td>31.12.07</td>
<td>96.1%</td>
<td>8.2</td>
<td>1.0</td>
<td>2.8</td>
<td>9.1</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>0.7</td>
<td>0.0</td>
</tr>
<tr>
<td>SMITH &amp; NEPHEW</td>
<td>31.12.07</td>
<td>88.9%</td>
<td>1.0</td>
<td>6.0</td>
<td>23.0</td>
<td>9.0</td>
<td>(14.0)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>(3.0)</td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>31.03.08</td>
<td>100.0%</td>
<td>1,425.4</td>
<td>507.4</td>
<td>1,542.7</td>
<td>472.8</td>
<td>18.1</td>
<td>(24.5)</td>
<td>0.0</td>
<td>0.0</td>
<td>20.7</td>
</tr>
<tr>
<td>SEVERN TRENT</td>
<td>31.03.08</td>
<td>96.2%</td>
<td>56.6</td>
<td>20.7</td>
<td>82.7</td>
<td>123.3</td>
<td>(2.3)</td>
<td>6.2</td>
<td>(2.1)</td>
<td>0.7</td>
<td>(24.3)</td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>31.03.08</td>
<td>100.0%</td>
<td>1,425.4</td>
<td>507.4</td>
<td>1,542.7</td>
<td>472.8</td>
<td>18.1</td>
<td>(24.5)</td>
<td>0.0</td>
<td>0.0</td>
<td>20.7</td>
</tr>
<tr>
<td>SHIRE</td>
<td>31.12.07</td>
<td>96.1%</td>
<td>8.2</td>
<td>1.0</td>
<td>2.8</td>
<td>9.1</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>0.7</td>
<td>0.0</td>
</tr>
<tr>
<td>SMITH &amp; NEPHEW</td>
<td>31.12.07</td>
<td>88.9%</td>
<td>1.0</td>
<td>6.0</td>
<td>23.0</td>
<td>9.0</td>
<td>(14.0)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>(3.0)</td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>31.03.08</td>
<td>100.0%</td>
<td>1,425.4</td>
<td>507.4</td>
<td>1,542.7</td>
<td>472.8</td>
<td>18.1</td>
<td>(24.5)</td>
<td>0.0</td>
<td>0.0</td>
<td>20.7</td>
</tr>
<tr>
<td>SEVERN TRENT</td>
<td>31.03.08</td>
<td>96.2%</td>
<td>56.6</td>
<td>20.7</td>
<td>82.7</td>
<td>123.3</td>
<td>(2.3)</td>
<td>6.2</td>
<td>(2.1)</td>
<td>0.7</td>
<td>(24.3)</td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>31.03.08</td>
<td>100.0%</td>
<td>1,425.4</td>
<td>507.4</td>
<td>1,542.7</td>
<td>472.8</td>
<td>18.1</td>
<td>(24.5)</td>
<td>0.0</td>
<td>0.0</td>
<td>20.7</td>
</tr>
<tr>
<td>SHIRE</td>
<td>31.12.07</td>
<td>96.1%</td>
<td>8.2</td>
<td>1.0</td>
<td>2.8</td>
<td>9.1</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>0.7</td>
<td>0.0</td>
</tr>
<tr>
<td>SMITH &amp; NEPHEW</td>
<td>31.12.07</td>
<td>88.9%</td>
<td>1.0</td>
<td>6.0</td>
<td>23.0</td>
<td>9.0</td>
<td>(14.0)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>(3.0)</td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>31.03.08</td>
<td>100.0%</td>
<td>1,425.4</td>
<td>507.4</td>
<td>1,542.7</td>
<td>472.8</td>
<td>18.1</td>
<td>(24.5)</td>
<td>0.0</td>
<td>0.0</td>
<td>20.7</td>
</tr>
<tr>
<td>SEVERN TRENT</td>
<td>31.03.08</td>
<td>96.2%</td>
<td>56.6</td>
<td>20.7</td>
<td>82.7</td>
<td>123.3</td>
<td>(2.3)</td>
<td>6.2</td>
<td>(2.1)</td>
<td>0.7</td>
<td>(24.3)</td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>31.03.08</td>
<td>100.0%</td>
<td>1,425.4</td>
<td>507.4</td>
<td>1,542.7</td>
<td>472.8</td>
<td>18.1</td>
<td>(24.5)</td>
<td>0.0</td>
<td>0.0</td>
<td>20.7</td>
</tr>
<tr>
<td>SHIRE</td>
<td>31.12.07</td>
<td>96.1%</td>
<td>8.2</td>
<td>1.0</td>
<td>2.8</td>
<td>9.1</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>0.7</td>
<td>0.0</td>
</tr>
<tr>
<td>SMITH &amp; NEPHEW</td>
<td>31.12.07</td>
<td>88.9%</td>
<td>1.0</td>
<td>6.0</td>
<td>23.0</td>
<td>9.0</td>
<td>(14.0)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>(3.0)</td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>31.03.08</td>
<td>100.0%</td>
<td>1,425.4</td>
<td>507.4</td>
<td>1,542.7</td>
<td>472.8</td>
<td>18.1</td>
<td>(24.5)</td>
<td>0.0</td>
<td>0.0</td>
<td>20.7</td>
</tr>
<tr>
<td>SEVERN TRENT</td>
<td>31.03.08</td>
<td>96.2%</td>
<td>56.6</td>
<td>20.7</td>
<td>82.7</td>
<td>123.3</td>
<td>(2.3)</td>
<td>6.2</td>
<td>(2.1)</td>
<td>0.7</td>
<td>(24.3)</td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>31.03.08</td>
<td>100.0%</td>
<td>1,425.4</td>
<td>507.4</td>
<td>1,542.7</td>
<td>472.8</td>
<td>18.1</td>
<td>(24.5)</td>
<td>0.0</td>
<td>0.0</td>
<td>20.7</td>
</tr>
<tr>
<td>SHIRE</td>
<td>31.12.07</td>
<td>96.1%</td>
<td>8.2</td>
<td>1.0</td>
<td>2.8</td>
<td>9.1</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>0.7</td>
<td>0.0</td>
</tr>
<tr>
<td>SMITH &amp; NEPHEW</td>
<td>31.12.07</td>
<td>88.9%</td>
<td>1.0</td>
<td>6.0</td>
<td>23.0</td>
<td>9.0</td>
<td>(14.0)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>(3.0)</td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>31.03.08</td>
<td>100.0%</td>
<td>1,425.4</td>
<td>507.4</td>
<td>1,542.7</td>
<td>472.8</td>
<td>18.1</td>
<td>(24.5)</td>
<td>0.0</td>
<td>0.0</td>
<td>20.7</td>
</tr>
<tr>
<td>SEVERN TRENT</td>
<td>31.03.08</td>
<td>96.2%</td>
<td>56.6</td>
<td>20.7</td>
<td>82.7</td>
<td>123.3</td>
<td>(2.3)</td>
<td>6.2</td>
<td>(2.1)</td>
<td>0.7</td>
<td>(24.3)</td>
</tr>
<tr>
<td></td>
<td>Mkt (1) Shares traded (000s)</td>
<td>Mkt (2) No shares at beg of yr (000s)</td>
<td>Marketability Mkt [1] / Mkt [2]</td>
<td>Volatility per share measure volatility measure [1][2]</td>
<td>Dividend per share pence</td>
<td>Managerial ownership</td>
<td>Listing status (1 = multiple; 0 = only LSE)</td>
<td>Reported news items (RNI) No. of analysts following (AF)</td>
<td>News / analyst following (RNI + AF) Oil &amp; Gas (1 = yes; 0 = no) Mining (1 = yes; 0 = no)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-----------------------</td>
<td>-----------------------------</td>
<td>----------------------------------------</td>
<td>---------------------------------</td>
<td>------------------------------------------------</td>
<td>--------------------------</td>
<td>---------------------</td>
<td>---------------------------------------------</td>
<td>-------------------------------------------------</td>
<td>-------------------------------------------------</td>
<td>-----------------------------------------</td>
<td></td>
</tr>
<tr>
<td>ANGLO AMERICAN</td>
<td>2,140,429</td>
<td>1,322,128</td>
<td>1.62</td>
<td>26.74 10.00 1.15</td>
<td>2.58%</td>
<td>1</td>
<td>257 17</td>
<td>15.12</td>
<td>0 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AMEC</td>
<td>1,119,547</td>
<td>333,710</td>
<td>3.35</td>
<td>34.97 8.00 12.60</td>
<td>0.45%</td>
<td>1</td>
<td>98 18</td>
<td>5.44</td>
<td>1 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ANTOFAGASTA</td>
<td>1,805,143</td>
<td>985,857</td>
<td>1.83</td>
<td>27.29 11.00 4.11</td>
<td>4.26%</td>
<td>1</td>
<td>88 24</td>
<td>3.67</td>
<td>0 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ASTRAZENECA</td>
<td>2,272,223</td>
<td>1,457,001</td>
<td>1.56</td>
<td>24.92 4.00 84.89</td>
<td>0.06%</td>
<td>1</td>
<td>616 36</td>
<td>17.11</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BAE SYSTEMS</td>
<td>6,313,113</td>
<td>3,512,564</td>
<td>1.80</td>
<td>27.18 4.00 12.80</td>
<td>0.04%</td>
<td>1</td>
<td>246 24</td>
<td>10.25</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRIT AMER TOBACCO</td>
<td>2,133,355</td>
<td>2,017,616</td>
<td>1.06</td>
<td>21.04 4.00 58.80</td>
<td>0.09%</td>
<td>1</td>
<td>192 18</td>
<td>10.67</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRITISH AIRWAYS</td>
<td>4,285,876</td>
<td>1,151,018</td>
<td>3.72</td>
<td>36.18 8.00 -</td>
<td>0.03%</td>
<td>1</td>
<td>158 23</td>
<td>6.87</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BG GROUP</td>
<td>4,078,711</td>
<td>3,361,100</td>
<td>1.21</td>
<td>24.96 4.00 7.80</td>
<td>0.10%</td>
<td>1</td>
<td>243 29</td>
<td>8.38</td>
<td>1 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRITISH ENERGY</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a n/a</td>
<td>13.78</td>
<td>1 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRIT LAND CO</td>
<td>1,941,740</td>
<td>627,441</td>
<td>3.09</td>
<td>25.98 6.00 28.59</td>
<td>0.10%</td>
<td>1</td>
<td>125 21</td>
<td>5.95</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BUNZL</td>
<td>549,022</td>
<td>326,510</td>
<td>1.68</td>
<td>18.43 4.00 17.50</td>
<td>0.36%</td>
<td>1</td>
<td>96 15</td>
<td>6.40</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BP</td>
<td>22,290,499</td>
<td>18,922,780</td>
<td>1.18</td>
<td>16.45 4.00 20.99</td>
<td>0.01%</td>
<td>1</td>
<td>392 37</td>
<td>10.59</td>
<td>1 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BT GROUP</td>
<td>11,709,641</td>
<td>7,793,942</td>
<td>1.50</td>
<td>22.13 9.00 15.40</td>
<td>0.14%</td>
<td>1</td>
<td>318 28</td>
<td>11.36</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CADBURY ADR</td>
<td>15,390,456</td>
<td>1,893,502</td>
<td>8.13</td>
<td>15.73 8.00 16.60</td>
<td>0.16%</td>
<td>1</td>
<td>277 24</td>
<td>11.54</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CENTRICA</td>
<td>5,506,011</td>
<td>5,202,683</td>
<td>1.06</td>
<td>18.22 4.00 10.10</td>
<td>0.08%</td>
<td>1</td>
<td>105 17</td>
<td>6.18</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAIRN ENERGY</td>
<td>501,547</td>
<td>130,787</td>
<td>3.83</td>
<td>49.61 8.00 -</td>
<td>0.80%</td>
<td>1</td>
<td>114 21</td>
<td>5.43</td>
<td>1 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>COBHAM</td>
<td>1,588,447</td>
<td>1,135,355</td>
<td>1.40</td>
<td>36.79 5.00 3.86</td>
<td>0.06%</td>
<td>1</td>
<td>57 19</td>
<td>3.00</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAPITA GRP CARPHONE WAREHOUSE</td>
<td>982,639</td>
<td>609,000</td>
<td>1.61</td>
<td>24.86 3.00 10.27</td>
<td>0.28%</td>
<td>1</td>
<td>89 16</td>
<td>5.56</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DIAGEO</td>
<td>3,605,943</td>
<td>2,650,000</td>
<td>1.36</td>
<td>16.44 4.00 31.70</td>
<td>0.16%</td>
<td>1</td>
<td>165 24</td>
<td>6.88</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EURASIAN NATURAL</td>
<td>n/a</td>
<td>1,287,750</td>
<td>-</td>
<td>n/a 17.00 -</td>
<td>0.15%</td>
<td>1</td>
<td>n/a n/a</td>
<td>0</td>
<td>1 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ENTERPRISE INNS</td>
<td>1,504,129</td>
<td>511,467</td>
<td>2.94</td>
<td>30.88 17.00 15.60</td>
<td>1.15%</td>
<td>1</td>
<td>85 22</td>
<td>3.86</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FIRSTGROUP</td>
<td>972,262</td>
<td>437,824</td>
<td>2.22</td>
<td>25.80 8.00 16.00</td>
<td>0.47%</td>
<td>1</td>
<td>111 15</td>
<td>7.40</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GAS</td>
<td>2,031,110</td>
<td>1,280,711</td>
<td>1.59</td>
<td>n/a 5.00 4.63</td>
<td>12.77%</td>
<td>1</td>
<td>93 15</td>
<td>6.20</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GLAXOSMITHLINE</td>
<td>6,457,418</td>
<td>5,508,393</td>
<td>1.17</td>
<td>16.31 4.00 51.00</td>
<td>0.06%</td>
<td>1</td>
<td>555 33</td>
<td>16.82</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HAMMERSON</td>
<td>544,778</td>
<td>426,048</td>
<td>1.28</td>
<td>29.29 8.00 18.53</td>
<td>0.15%</td>
<td>1</td>
<td>66 20</td>
<td>3.30</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HOME RETAIL GROUP</td>
<td>2,385,421</td>
<td>877,400</td>
<td>2.72</td>
<td>n/a 7.00 13.70</td>
<td>0.99%</td>
<td>1</td>
<td>92 20</td>
<td>4.60</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>INTERCONT HOTELS INTERNATIONAL POWER</td>
<td>997,290</td>
<td>294,623</td>
<td>3.38</td>
<td>23.21 8.00 19.27</td>
<td>1.24%</td>
<td>1</td>
<td>185 22</td>
<td>8.41</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ITV JOHNSTON MATTHEY PLC</td>
<td>3,064,318</td>
<td>1,501,940</td>
<td>2.04</td>
<td>27.55 5.00 10.67</td>
<td>0.33%</td>
<td>1</td>
<td>86 12</td>
<td>7.17</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>KAZAKHMYS</td>
<td>881,903</td>
<td>460,123</td>
<td>1.92</td>
<td>n/a 20.00 0.39</td>
<td>47.61%</td>
<td>1</td>
<td>44 15</td>
<td>2.93</td>
<td>0 0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company Name</td>
<td>Value</td>
<td>Change</td>
<td>YTD Return</td>
<td>P/E Ratio</td>
<td>Dividend</td>
<td>No. of Shares</td>
<td>P/S Ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>------------------------------</td>
<td>-----------</td>
<td>----------</td>
<td>------------</td>
<td>-----------</td>
<td>-----------</td>
<td>--------------</td>
<td>-----------</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>KINGFISHER</td>
<td>7,939,202</td>
<td>2,360,808</td>
<td>3.36</td>
<td>25.66</td>
<td>10.00</td>
<td>10.65</td>
<td>0.06%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LAND SEC</td>
<td>1,189,491</td>
<td>955,071</td>
<td>1.90</td>
<td>20.00</td>
<td>10.00</td>
<td>56.56</td>
<td>0.22%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LIBERTY INT</td>
<td>1,48,184</td>
<td>640,963</td>
<td>1.67</td>
<td>18.57</td>
<td>7.00</td>
<td>31.86</td>
<td>0.56%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MARKS &amp; SPENCER</td>
<td>1,113,906</td>
<td>4,506,803</td>
<td>2.84</td>
<td>25.28</td>
<td>8.00</td>
<td>20.30</td>
<td>0.30%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MORRISON SUPERMARKETS</td>
<td>1,163,906</td>
<td>5,791,860</td>
<td>2.16</td>
<td>20.87</td>
<td>3.00</td>
<td>4.05</td>
<td>16.19%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NATIONAL GRID</td>
<td>1,118,906</td>
<td>3,388,177</td>
<td>1.35</td>
<td>15.93</td>
<td>4.00</td>
<td>29.50</td>
<td>0.16%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NEXT</td>
<td>1,231,906</td>
<td>897,087</td>
<td>4.46</td>
<td>23.07</td>
<td>9.00</td>
<td>51.50</td>
<td>0.97%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PERSIMMON PLC</td>
<td>1,141,906</td>
<td>824,422</td>
<td>2.72</td>
<td>25.53</td>
<td>10.00</td>
<td>51.20</td>
<td>1.48%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PEARSON</td>
<td>1,186,906</td>
<td>1,602,011</td>
<td>1.98</td>
<td>19.23</td>
<td>5.00</td>
<td>29.90</td>
<td>0.61%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RECKIT &amp; BENCK GRP</td>
<td>262,906</td>
<td>93,294</td>
<td>0.13</td>
<td>17.23</td>
<td>4.00</td>
<td>50.00</td>
<td>0.93%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROYAL DUTCH SHELL</td>
<td>2,141,906</td>
<td>2,520,677</td>
<td>0.41</td>
<td>16.61</td>
<td>4.00</td>
<td>69.84</td>
<td>0.01%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>REED ELSEVIER</td>
<td>1,197,906</td>
<td>2,013,812</td>
<td>1.93</td>
<td>15.91</td>
<td>4.00</td>
<td>16.54</td>
<td>0.14%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>REXAM</td>
<td>1,141,906</td>
<td>1,314,541</td>
<td>1.82</td>
<td>19.45</td>
<td>5.00</td>
<td>17.28</td>
<td>0.08%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RIO TINTO</td>
<td>2,118,906</td>
<td>2,761,776</td>
<td>1.78</td>
<td>26.81</td>
<td>12.00</td>
<td>48.10</td>
<td>0.02%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROLLS-ROYCE GROUP</td>
<td>2,103,906</td>
<td>3,661,142</td>
<td>0.03</td>
<td>30.38</td>
<td>9.00</td>
<td>-</td>
<td>0.16%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SABMILLER</td>
<td>1,110,906</td>
<td>1,421,808</td>
<td>0.90</td>
<td>20.74</td>
<td>7.00</td>
<td>0.52</td>
<td>0.42%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SAINSbury</td>
<td>1,193,906</td>
<td>4,958,573</td>
<td>2.84</td>
<td>24.06</td>
<td>3.00</td>
<td>10.35</td>
<td>0.23%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SHIRE</td>
<td>1,504,906</td>
<td>1,377,006</td>
<td>2.47</td>
<td>25.23</td>
<td>5.00</td>
<td>3.74</td>
<td>0.24%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SMITH &amp; NEPHEW</td>
<td>1,188,906</td>
<td>1,687,614</td>
<td>1.78</td>
<td>16.27</td>
<td>4.00</td>
<td>5.63</td>
<td>0.08%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>1,184,906</td>
<td>1,243,627</td>
<td>1.43</td>
<td>16.35</td>
<td>3.00</td>
<td>58.00</td>
<td>0.05%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SEVERN TRENT</td>
<td>1,141,906</td>
<td>534,472</td>
<td>2.28</td>
<td>17.29</td>
<td>4.00</td>
<td>63.02</td>
<td>0.02%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TATE &amp; LYLE</td>
<td>1,111,906</td>
<td>1,475,155</td>
<td>1.34</td>
<td>24.86</td>
<td>9.00</td>
<td>21.50</td>
<td>0.29%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TULLOW OIL THOMSON REUTERS</td>
<td>1,129,906</td>
<td>1,721,224</td>
<td>1.82</td>
<td>19.45</td>
<td>5.00</td>
<td>17.28</td>
<td>0.08%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TESCO PLC</td>
<td>7,141,906</td>
<td>9,479,367</td>
<td>1.21</td>
<td>17.01</td>
<td>4.00</td>
<td>10.03</td>
<td>0.24%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TUI TRAVEL</td>
<td>48,131,906</td>
<td>662,118,011</td>
<td>0.00</td>
<td>1,118,011</td>
<td>4.00</td>
<td>7.90</td>
<td>0.49%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UNILEVER</td>
<td>1,340,906</td>
<td>1,896,884</td>
<td>0.66</td>
<td>20.17</td>
<td>5.00</td>
<td>47.66</td>
<td>0.02%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UNITED UTILITIES GR</td>
<td>1,504,906</td>
<td>1,654,196</td>
<td>1.88</td>
<td>13.39</td>
<td>6.00</td>
<td>44.93</td>
<td>0.03%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VODAFONE GRP</td>
<td>334,906</td>
<td>68,644,796</td>
<td>1.29</td>
<td>31.78</td>
<td>4.00</td>
<td>6.90</td>
<td>0.04%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WOOD GROUP (JOHN)</td>
<td>173,906</td>
<td>764,497</td>
<td>1.46</td>
<td>24.86</td>
<td>8.00</td>
<td>0.05</td>
<td>18.16%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WPP GRP</td>
<td>296,906</td>
<td>2,501,210</td>
<td>2.10</td>
<td>26.67</td>
<td>7.00</td>
<td>11.93</td>
<td>1.35%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WHITBREAD</td>
<td>1,132,906</td>
<td>631,874</td>
<td>3.60</td>
<td>25.41</td>
<td>8.00</td>
<td>31.25</td>
<td>0.23%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>XISTRATA</td>
<td>17,716,906</td>
<td>4,242,696</td>
<td>2.47</td>
<td>43.21</td>
<td>15.00</td>
<td>0.26</td>
<td>0.13%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>Market capitalisation</td>
<td>Size (log of total assets)</td>
<td>Total assets (presentational currency)</td>
<td>Gearing</td>
<td>Profitability</td>
<td>Liquidity (current ratio)</td>
<td>Interest cover</td>
<td>New share issue (1 = yes; 0 = no)</td>
<td>Auditor</td>
<td></td>
<td></td>
</tr>
<tr>
<td>---------</td>
<td>----------------------</td>
<td>---------------------------</td>
<td>--------------------------------------</td>
<td>---------</td>
<td>--------------</td>
<td>--------------------------</td>
<td>----------------</td>
<td>---------------------------------</td>
<td>---------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ANGLO AMERICAN</td>
<td>40,721,550</td>
<td>10.02</td>
<td>44,762</td>
<td>9.9%</td>
<td>19.9%</td>
<td>0.87</td>
<td>16.78</td>
<td>0</td>
<td>Deloitte</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AMEC</td>
<td>2,794,813</td>
<td>7.50</td>
<td>1,817</td>
<td>0.0%</td>
<td>7.3%</td>
<td>1.81</td>
<td>89.47</td>
<td>1</td>
<td>KPMG</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ANTOFAGASTA</td>
<td>7,088,170</td>
<td>7.99</td>
<td>5,856</td>
<td>3.3%</td>
<td>45.3%</td>
<td>7.94</td>
<td>131.90</td>
<td>0</td>
<td>Deloitte</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ASTRAZENECA</td>
<td>31,529,500</td>
<td>10.09</td>
<td>47,957</td>
<td>72.9%</td>
<td>16.9%</td>
<td>1.12</td>
<td>16.29</td>
<td>1</td>
<td>KPMG</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BAE SYSTEMS</td>
<td>13,243,740</td>
<td>9.92</td>
<td>20,260</td>
<td>36.6%</td>
<td>5.8%</td>
<td>0.73</td>
<td>9.58</td>
<td>1</td>
<td>KPMG</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRIT AMER TOBACCO</td>
<td>39,666,050</td>
<td>9.84</td>
<td>18,728</td>
<td>3.3%</td>
<td>45.3%</td>
<td>7.94</td>
<td>131.90</td>
<td>0</td>
<td>Deloitte</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRITISH AIRWAYS</td>
<td>5,602,412</td>
<td>9.32</td>
<td>11,123</td>
<td>85.4%</td>
<td>7.9%</td>
<td>0.97</td>
<td>6.32</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BG GROUP</td>
<td>38,619,040</td>
<td>9.64</td>
<td>15,390</td>
<td>22.7%</td>
<td>16.9%</td>
<td>1.30</td>
<td>25.17</td>
<td>1</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRITISH ENERGY</td>
<td>n/a</td>
<td>9.42</td>
<td>12,346</td>
<td>9.1%</td>
<td>4.1%</td>
<td>2.39</td>
<td>n/a</td>
<td>1</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRIT LAND CO</td>
<td>4,769,921</td>
<td>9.45</td>
<td>12,648</td>
<td>75.9%</td>
<td>-10.4%</td>
<td>0.67</td>
<td>(3.19)</td>
<td>1</td>
<td>Deloitte</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BUNZL</td>
<td>2,318,219</td>
<td>7.64</td>
<td>2,082</td>
<td>31.5%</td>
<td>10.5%</td>
<td>1.26</td>
<td>6.48</td>
<td>0</td>
<td>KPMG</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BP</td>
<td>116,375,100</td>
<td>11.69</td>
<td>236,036</td>
<td>32.8%</td>
<td>13.7%</td>
<td>1.04</td>
<td>26.03</td>
<td>0</td>
<td>Young</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BT GROUP</td>
<td>16,932,340</td>
<td>10.29</td>
<td>29,352</td>
<td>209.8%</td>
<td>8.0%</td>
<td>0.67</td>
<td>3.42</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CADBURY ADR</td>
<td>13,096,890</td>
<td>9.34</td>
<td>11,338</td>
<td>87.2%</td>
<td>7.0%</td>
<td>0.58</td>
<td>4.34</td>
<td>0</td>
<td>Deloitte</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CENTRICA</td>
<td>13,201,930</td>
<td>7.08</td>
<td>1,185</td>
<td>53.0%</td>
<td>18.4%</td>
<td>1.07</td>
<td>12.77</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAIRN ENERGY</td>
<td>4,019,085</td>
<td>7.09</td>
<td>2,381</td>
<td>4.3%</td>
<td>-3.2%</td>
<td>4.18</td>
<td>214.83</td>
<td>0</td>
<td>Young</td>
<td></td>
<td></td>
</tr>
<tr>
<td>COHIBAM</td>
<td>2,367,216</td>
<td>7.37</td>
<td>1,591</td>
<td>45.5%</td>
<td>10.4%</td>
<td>1.53</td>
<td>10.02</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAPITA GRP CARPHONE WAREHOUSE</td>
<td>4,244,730</td>
<td>7.31</td>
<td>1,491</td>
<td>162.1%</td>
<td>17.5%</td>
<td>0.70</td>
<td>7.41</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ENTERPRISE INNS</td>
<td>2,639,175</td>
<td>7.97</td>
<td>2,889</td>
<td>127.0%</td>
<td>5.8%</td>
<td>0.89</td>
<td>(1.48)</td>
<td>0</td>
<td>Deloitte</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DIAGEO</td>
<td>27,507,010</td>
<td>9.54</td>
<td>13,956</td>
<td>136.0%</td>
<td>15.5%</td>
<td>1.24</td>
<td>6.86</td>
<td>0</td>
<td>KPMG</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EYROSIS NATURAL</td>
<td>8,273,794</td>
<td>8.33</td>
<td>8,188</td>
<td>24.6%</td>
<td>17.4%</td>
<td>4.38</td>
<td>9.58</td>
<td>1</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ENTERPRISE INNS</td>
<td>3,030,442</td>
<td>8.76</td>
<td>6,356</td>
<td>259.9%</td>
<td>12.2%</td>
<td>0.61</td>
<td>1.84</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FIRSTGROUP</td>
<td>2,467,137</td>
<td>8.48</td>
<td>4,816</td>
<td>330.3%</td>
<td>5.6%</td>
<td>0.84</td>
<td>2.32</td>
<td>0</td>
<td>Deloitte</td>
<td></td>
<td></td>
</tr>
<tr>
<td>G4S</td>
<td>3,137,740</td>
<td>8.21</td>
<td>3,676</td>
<td>98.0%</td>
<td>7.4%</td>
<td>1.25</td>
<td>3.89</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GLAXOSMITHKLINE</td>
<td>70,452,350</td>
<td>10.34</td>
<td>31,003</td>
<td>108.7%</td>
<td>24.5%</td>
<td>1.32</td>
<td>18.06</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HAMMERSOM</td>
<td>2,963,956</td>
<td>8.94</td>
<td>7,622</td>
<td>57.0%</td>
<td>3.4%</td>
<td>0.20</td>
<td>1.85</td>
<td>1</td>
<td>Deloitte</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HOME RETAIL GROUP</td>
<td>2,274,660</td>
<td>8.45</td>
<td>4,693</td>
<td>n/a</td>
<td>8.2%</td>
<td>1.54</td>
<td>129.61</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>INTERCONT HOTELS INTERNATIONAL POWER</td>
<td>2,602,994</td>
<td>7.50</td>
<td>1,807</td>
<td>1789.8%</td>
<td>14.8%</td>
<td>0.67</td>
<td>5.11</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>JT V JOHNSON MATTHEY PLC</td>
<td>3,325,204</td>
<td>8.65</td>
<td>5,720</td>
<td>40.0%</td>
<td>3.4%</td>
<td>1.48</td>
<td>4.26</td>
<td>0</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>KAZAHIAMS</td>
<td>6,299,088</td>
<td>8.22</td>
<td>7,354</td>
<td>3.0%</td>
<td>27.8%</td>
<td>6.05</td>
<td>98.40</td>
<td>1</td>
<td>PwC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>Shares</td>
<td>Price</td>
<td>Yield</td>
<td>EPS</td>
<td>P/E</td>
<td>Div Yld</td>
<td>Div P/E</td>
<td>Analyst</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>--------------------------</td>
<td>--------</td>
<td>--------</td>
<td>-------</td>
<td>------</td>
<td>-----</td>
<td>---------</td>
<td>---------</td>
<td>---------</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>KINGFISHER</td>
<td>3,560,098</td>
<td>9.15</td>
<td>9.403</td>
<td>34.3%</td>
<td>4.9%</td>
<td>1.03</td>
<td>4.76</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LAND SEC</td>
<td>7,007,610</td>
<td>9.72</td>
<td>16,615</td>
<td>48.3%</td>
<td>-3.0%</td>
<td>0.73</td>
<td>(1.73)</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LIBERTY INT</td>
<td>3,928,828</td>
<td>9.12</td>
<td>9.173</td>
<td>78.7%</td>
<td>60.0%</td>
<td>0.77</td>
<td>0.40</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MARKS &amp; SPENCER</td>
<td>6,286,421</td>
<td>8.88</td>
<td>7.161</td>
<td>86.3%</td>
<td>16.9%</td>
<td>0.59</td>
<td>5.25</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MORRISON SUPERMARKETS</td>
<td>8,031,140</td>
<td>8.94</td>
<td>7.636</td>
<td>17.7%</td>
<td>8.0%</td>
<td>0.49</td>
<td>14.30</td>
<td>KPMG</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NATIONAL GRID</td>
<td>21,554,190</td>
<td>10.54</td>
<td>37,822</td>
<td>-682.3%</td>
<td>32.9%</td>
<td>0.98</td>
<td>3.21</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NEXT</td>
<td>2,761,694</td>
<td>7.40</td>
<td>1,630</td>
<td>22.5%</td>
<td>32.9%</td>
<td>0.94</td>
<td>9.71</td>
<td>Ernst &amp; Young</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PERSIMMON PLC</td>
<td>2,423,757</td>
<td>8.33</td>
<td>4,156</td>
<td>22.5%</td>
<td>15.8%</td>
<td>3.43</td>
<td>8.85</td>
<td>KPMG</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PEARSON</td>
<td>5,930,764</td>
<td>8.89</td>
<td>7,292</td>
<td>27.1%</td>
<td>7.9%</td>
<td>1.45</td>
<td>4.90</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RECKITT BENCK GRP</td>
<td>20,020,930</td>
<td>8.68</td>
<td>5,868</td>
<td>19.1%</td>
<td>21.0%</td>
<td>1.03</td>
<td>3.39</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROYAL DUTCH SHELL</td>
<td>56,934,940</td>
<td>11.82</td>
<td>269,470</td>
<td>8.6%</td>
<td>18.2%</td>
<td>0.82</td>
<td>90.04</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>REED ELSEVIER</td>
<td>8,623,610</td>
<td>9.19</td>
<td>9,778</td>
<td>105.1%</td>
<td>9.1%</td>
<td>1.15</td>
<td>n/a</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>REXAM</td>
<td>2,686,027</td>
<td>8.55</td>
<td>5,159</td>
<td>-682.3%</td>
<td>7.2%</td>
<td>1.03</td>
<td>3.39</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RIO TINTO</td>
<td>53,023,780</td>
<td>10.84</td>
<td>101,391</td>
<td>146.7%</td>
<td>10.0%</td>
<td>1.11</td>
<td>16.29</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROLLs-ROYCE GROUP</td>
<td>9,919,001</td>
<td>9.35</td>
<td>11,459</td>
<td>29.0%</td>
<td>4.5%</td>
<td>1.53</td>
<td>8.49</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SABMILLER</td>
<td>16,638,670</td>
<td>9.80</td>
<td>35,813</td>
<td>49.9%</td>
<td>9.6%</td>
<td>0.66</td>
<td>5.31</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SANSIBURY</td>
<td>5,813,187</td>
<td>9.22</td>
<td>10,115</td>
<td>42.2%</td>
<td>5.2%</td>
<td>0.66</td>
<td>5.09</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SHIRE</td>
<td>6,377,330</td>
<td>8.41</td>
<td>8,895</td>
<td>17.6%</td>
<td>80.0%</td>
<td>0.96</td>
<td>3.35</td>
<td>Deloitte</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SMITH &amp; NEPHEW</td>
<td>5,495,546</td>
<td>7.72</td>
<td>4,450</td>
<td>2.0%</td>
<td>11.1%</td>
<td>1.19</td>
<td>12.72</td>
<td>Ernst &amp; Young</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SCOT &amp; STHN ENERGY</td>
<td>12,216,510</td>
<td>9.55</td>
<td>13,976</td>
<td>69.6%</td>
<td>8.0%</td>
<td>0.77</td>
<td>9.13</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SEVERN TRENT</td>
<td>3,328,860</td>
<td>8.86</td>
<td>7,063</td>
<td>301.0%</td>
<td>5.7%</td>
<td>1.51</td>
<td>1.91</td>
<td>Deloitte</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TATE &amp; LYLE</td>
<td>2,468,639</td>
<td>8.11</td>
<td>3,334</td>
<td>90.3%</td>
<td>6.4%</td>
<td>1.41</td>
<td>3.19</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TULLOW OIL</td>
<td>4,688,263</td>
<td>7.65</td>
<td>2,091</td>
<td>75.8%</td>
<td>9.0%</td>
<td>0.96</td>
<td>3.35</td>
<td>Deloitte</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>THOMSON REUTERS</td>
<td>n/a</td>
<td>7.60</td>
<td>1,993</td>
<td>450.1%</td>
<td>14.7%</td>
<td>0.44</td>
<td>n/a</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TESCO PLC</td>
<td>31,473,650</td>
<td>10.31</td>
<td>30,164</td>
<td>55.4%</td>
<td>9.3%</td>
<td>0.61</td>
<td>8.11</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TUI TRAVEL</td>
<td>2,817,383</td>
<td>9.39</td>
<td>16,304</td>
<td>151.5%</td>
<td>2.6%</td>
<td>0.83</td>
<td>(1.10)</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UNILEVER</td>
<td>53,980,660</td>
<td>10.22</td>
<td>37,302</td>
<td>42.8%</td>
<td>14.1%</td>
<td>0.73</td>
<td>9.97</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UNITED UTILITIES GR</td>
<td>6,092,001</td>
<td>9.24</td>
<td>10,336</td>
<td>118.0%</td>
<td>6.4%</td>
<td>1.30</td>
<td>2.66</td>
<td>Deloitte</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VEDANTA RESOURCES</td>
<td>6,042,100</td>
<td>9.00</td>
<td>16,036</td>
<td>16.9%</td>
<td>16.2%</td>
<td>2.13</td>
<td>29.57</td>
<td>Deloitte</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VODAFONE GRP</td>
<td>80,161,940</td>
<td>11.75</td>
<td>127,270</td>
<td>29.6%</td>
<td>7.9%</td>
<td>0.40</td>
<td>5.55</td>
<td>Deloitte</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WOOD GROUP (JOHN)</td>
<td>2,267,756</td>
<td>7.81</td>
<td>2,471</td>
<td>35.5%</td>
<td>11.5%</td>
<td>1.59</td>
<td>8.95</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WPP GRP</td>
<td>7,690,061</td>
<td>9.76</td>
<td>17,252</td>
<td>42.5%</td>
<td>4.9%</td>
<td>1.17</td>
<td>4.13</td>
<td>Deloitte</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WHITBREAD</td>
<td>2,226,119</td>
<td>7.80</td>
<td>2,441</td>
<td>34.6%</td>
<td>7.2%</td>
<td>0.28</td>
<td>5.40</td>
<td>PwC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>XISTRATA</td>
<td>34,494,180</td>
<td>10.18</td>
<td>52,249</td>
<td>47.5%</td>
<td>17.3%</td>
<td>1.47</td>
<td>9.87</td>
<td>Young</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Supplement to Appendix A

Reconciliation of derivatives holdings by company and by instrument type (where possible)

<table>
<thead>
<tr>
<th>Company name</th>
<th>ANGLO AMERICAN</th>
<th>AMEC</th>
<th>ANTOFAGASTA</th>
<th>ASTRAZENECA</th>
<th>BAE SYSTEMS</th>
<th>BRIT AMER TOBACCO</th>
<th>BRITISH AIRWAYS</th>
<th>BG GROUP</th>
<th>BRITISH ENERGY</th>
</tr>
</thead>
</table>

**Reconciliation of derivative assets**

**Current assets**

- Forward foreign currency contracts: 34.0, 556.0, 8.0
- Forward commodity contracts: 0.0
- Foreign exchange option contracts: 97.0
- Cross currency swaps: 404.0, 30.0
- Interest rate swaps: 805.0, 515.0
- Fuel derivatives: 270.0

**Information not presented disaggregated (current assets)**

- Forward foreign exchange contracts and foreign exchange swaps: 3.1
- Commodity derivatives (futures, forwards, options [min/max]): 0.5
- Forward foreign exchange contracts, forward currency options and interest rate swaps: 86.0, 53.0
- Held for trading: 0.0
- Hedging instruments: 0.0
- Interest rate swaps and forward foreign exchange contracts: 0.0
- Currency and commodity contracts: 0.0
- Swap and forward exchange contracts: 0.0
- Foreign exchange derivatives: 0.0
- Interest rate derivatives: 0.0

**Non-current assets**

- Forward foreign currency contracts: 0.0
- Forward commodity contracts: 0.0
- Equity instruments: 0.0
- Other: 0.0
- Interest rate swaps: 805.0
- Cross currency swaps: 515.0
- Fuel derivatives: 80.0
### Information not presented disaggregated (non-current assets)

Commodity derivatives (futures, forwards, options [min/max])

Currency derivatives

Interest rate swaps and forward foreign exchange contracts

Currency and commodity contracts

Interest rate derivatives

### Not possible to differentiate current from non-current

<table>
<thead>
<tr>
<th>Description</th>
<th>Current</th>
<th>Non-current</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward/future foreign currency contracts</td>
<td>18.0</td>
<td>37.0</td>
</tr>
<tr>
<td>Forward commodity contracts</td>
<td></td>
<td>691.0</td>
</tr>
<tr>
<td>Commodity contracts - swaps, futures, options and forwards</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>32.0</td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td>171.0</td>
<td>132.0</td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>14.0</td>
<td>7.0</td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hedges of net investments in foreign operations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity collars, options and warrants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency risks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market risks</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Reconciliation of derivative liabilities

#### Current liabilities

<table>
<thead>
<tr>
<th>Description</th>
<th>Current</th>
<th>Non-current</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward foreign currency contracts</td>
<td>(37.0)</td>
<td>(958.0)</td>
</tr>
<tr>
<td>Forward commodity contracts</td>
<td>(304.0)</td>
<td></td>
</tr>
<tr>
<td>Foreign exchange option contracts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>(150.0)</td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td>(10.0)</td>
<td>(105.0)</td>
</tr>
<tr>
<td>Fuel derivatives</td>
<td></td>
<td>(38.0)</td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate collars</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity contracts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Information not presented disaggregated (current liabilities)

<table>
<thead>
<tr>
<th>Description</th>
<th>ANGLO AMERICAN</th>
<th>AMEC</th>
<th>ANTOFAGASTA</th>
<th>ASTRAZENECA</th>
<th>BAE SYSTEMS</th>
<th>BRIT AMER TOBACCO</th>
<th>BRITISH AIRWAYS</th>
<th>BG GROUP</th>
<th>BRITISH ENERGY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward foreign exchange contracts and foreign exchange swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity derivatives (futures, forwards, options [min/max])</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hedging instruments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps and forward foreign exchange contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Swap and forward exchange contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Non-current liabilities

<table>
<thead>
<tr>
<th>Description</th>
<th>ANGLO AMERICAN</th>
<th>AMEC</th>
<th>ANTOFAGASTA</th>
<th>ASTRAZENECA</th>
<th>BAE SYSTEMS</th>
<th>BRIT AMER TOBACCO</th>
<th>BRITISH AIRWAYS</th>
<th>BG GROUP</th>
<th>BRITISH ENERGY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward commodity contracts</td>
<td>(53.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>0.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>(32.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward currency contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Information not presented disaggregated (non-current liabilities)

<table>
<thead>
<tr>
<th>Description</th>
<th>ANGLO AMERICAN</th>
<th>AMEC</th>
<th>ANTOFAGASTA</th>
<th>ASTRAZENECA</th>
<th>BAE SYSTEMS</th>
<th>BRIT AMER TOBACCO</th>
<th>BRITISH AIRWAYS</th>
<th>BG GROUP</th>
<th>BRITISH ENERGY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps and forward foreign exchange contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Not possible to differentiate current from non-current

<table>
<thead>
<tr>
<th>Description</th>
<th>ANGLO AMERICAN</th>
<th>AMEC</th>
<th>ANTOFAGASTA</th>
<th>ASTRAZENECA</th>
<th>BAE SYSTEMS</th>
<th>BRIT AMER TOBACCO</th>
<th>BRITISH AIRWAYS</th>
<th>BG GROUP</th>
<th>BRITISH ENERGY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward/future foreign currency contracts</td>
<td>(141.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward/future commodity contracts</td>
<td>(70.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity contracts - swaps, futures, options and forwards</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>(35.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td>(1,081.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>(16.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaptions</td>
<td>(3.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity collars, options and warrants</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency risks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market risks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<p>| (586.0) | (5.3) | (1.4) | 0.0 | (1,063.0) | (274.0) | (90.0) | (1,170.0) | (142.0) |</p>
<table>
<thead>
<tr>
<th>Company name</th>
<th>BRIT LAND CO</th>
<th>BUNZL</th>
<th>BP</th>
<th>BT GROUP</th>
<th>CADBURY</th>
<th>CENTRICA</th>
<th>CAIRN ENERGY</th>
<th>COBHAM</th>
<th>CAPITA</th>
<th>GRP</th>
</tr>
</thead>
</table>

**Reconciliation of derivative assets**

**Current assets**

<p>| | | | | | | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward foreign currency contracts</td>
<td>38.0</td>
<td>0.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward commodity contracts</td>
<td>2.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange option contracts</td>
<td>2,479.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>5.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>17.0</td>
<td>2.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Information not presented disaggregated (current assets)**

<p>| | | | | | | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward foreign exchange contracts and foreign exchange swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity derivatives (futures, forwards, options [min/max])</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward foreign exchange contracts, forward currency options and interest rate swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Held for trading</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hedging instruments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps and forward foreign exchange contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency and commodity contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Swap and forward exchange contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Non-current assets**

<p>| | | | | | | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward foreign currency contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward commodity contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity instruments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>10.3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.1</td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.0</td>
<td></td>
</tr>
<tr>
<td>Fuel derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Information not presented disaggregated (non-current assets)
Commodity derivatives (futures, forwards, options [min/max])
Currency derivatives
Interest rate swaps and forward foreign exchange contracts
Currency and commodity contracts
Interest rate derivatives

<table>
<thead>
<tr>
<th>Information not presented disaggregated (non-current assets)</th>
<th>BRIT LAND CO</th>
<th>BUNZL</th>
<th>BP</th>
<th>BT GROUP</th>
<th>CADBURY ADR</th>
<th>CENTRICA</th>
<th>CAIRN ENERGY</th>
<th>COBHAM</th>
<th>CAPITA GRP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodity derivatives (futures, forwards, options [min/max])</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps and forward foreign exchange contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency and commodity contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Not possible to differentiate current from non-current
Forward/future foreign currency contracts 925.0 21.0 19.0 6.4
Forward commodity contracts 8,723.0 965.0
Commodity contracts - swaps, futures, options and forwards
Other 30.0
Cross currency swaps 340.0
Interest rate swaps 89.0 26.0 2.0 1.4
Embedded derivatives 255.0
Hedges of net investments in foreign operations 40.0
Equity collars, options and warrants
Currency risks
Market risks

<table>
<thead>
<tr>
<th>Reconciliation of derivative liabilities</th>
<th>BRIT LAND CO</th>
<th>BUNZL</th>
<th>BP</th>
<th>BT GROUP</th>
<th>CADBURY ADR</th>
<th>CENTRICA</th>
<th>CAIRN ENERGY</th>
<th>COBHAM</th>
<th>CAPITA GRP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward foreign currency contracts</td>
<td>(16.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward commodity contracts</td>
<td>(3.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange option contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>(31.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate collars</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRIT LAND CO</td>
<td>BUNZL</td>
<td>BP</td>
<td>BT GROUP</td>
<td>CADBURY ADR</td>
<td>CENTRICA</td>
<td>CAIRN ENERGY</td>
<td>COBHAM</td>
<td>CAPITA GRP</td>
<td></td>
</tr>
<tr>
<td>-------------</td>
<td>-------</td>
<td>----</td>
<td>----------</td>
<td>-------------</td>
<td>----------</td>
<td>---------------</td>
<td>--------</td>
<td>-----------</td>
<td></td>
</tr>
</tbody>
</table>

**Information not presented disaggregated (current liabilities)**

Forward foreign exchange contracts and foreign exchange swaps
Commodity derivatives (futures, forwards, options [min/max])
Held for trading
Hedging instruments
Interest rate swaps and forward foreign exchange contracts
Swap and forward foreign exchange contracts
Foreign exchange derivatives
Interest rate derivatives

**Non-current liabilities**
Forward commodity contracts
Other
Interest rate swaps
Forward currency contracts
Cross currency swaps

**Information not presented disaggregated (non-current liabilities)**
Currency derivatives
Interest rate swaps and forward foreign exchange contracts
Interest rate derivatives
Commodity derivatives

**Not possible to differentiate current from non-current**
Forward/future foreign currency contracts
(423.0) (1.0) (97.0)
Forward/future commodity contracts
(10,934.0) (1,306.0)
Commodity contracts - swaps, futures, options and forwards
Cross currency swaps
(625.0) (19.1)
Interest rate swaps
(50.0) (446.0) (12.0)
Interest rate swaptions
Equity collars, options and warrants
Embedded derivatives
Currency risks
Market risks

(31.0) (1.5) (11,407.0) (1,072.0) (25.0) (1,415.0) 0.0 0.0 (19.1)
<table>
<thead>
<tr>
<th>Company name</th>
<th>CARPHONE WAREHOUSE</th>
<th>DIAGEO</th>
<th>EURASIAN NATURAL</th>
<th>ENTERPRISE INNS</th>
<th>FIRSTGROUP</th>
<th>G4S</th>
<th>GLAXOSMITHKLINE</th>
<th>HAMMERSON</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year end</td>
<td>29.03.08</td>
<td>30.06.07</td>
<td>31.12.07</td>
<td>30.09.07</td>
<td>31.03.08</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>31.12.07</td>
</tr>
</tbody>
</table>

**Reconciliation of derivative assets**

**Current assets**

- Forward foreign currency contracts: 37.0
- Forward commodity contracts
- Foreign exchange option contracts
- Other: 7.0
- Cross currency swaps
- Interest rate swaps: 8.0
- Fuel derivatives: 67.6
- Embedded derivatives

**Information not presented disaggregated (current assets)**

- Forward foreign exchange contracts and foreign exchange swaps
- Commodity derivatives (futures, forwards, options [min/max])
- Forward foreign exchange contracts, forward currency options and interest rate swaps
- Held for trading
- Hedging instruments
- Interest rate swaps and forward foreign exchange contracts
- Currency and commodity contracts
- Swap and forward exchange contracts
- Foreign exchange derivatives
- Interest rate derivatives

**Non-current assets**

- Forward foreign currency contracts: 74.0
- Forward commodity contracts
- Equity instruments
- Other: 4.0
- Cross currency swaps: 23.9
- Fuel derivatives: 20.0
Information not presented disaggregated (non-current assets)
Commodity derivatives (futures, forwards, options [min/max])
Currency derivatives 4.0
Interest rate swaps and forward foreign exchange contracts
Currency and commodity contracts
Interest rate derivatives

Not possible to differentiate current from non-current
Forward/future foreign currency contracts 287.0
Forward commodity contracts
Commodity contracts - swaps, futures, options and forwards
Other
Cross currency swaps 168.0
Interest rate swaps 7.0
Embedded derivatives 3.0
Hedges of net investments in foreign operations
Equity collars, options and warrants 11.0
Currency risks
Market risks

<table>
<thead>
<tr>
<th></th>
<th>CARPHONE WAREHOUSE</th>
<th>DIAGEO</th>
<th>EURASIAN NATURAL</th>
<th>ENTERPRISE INNS</th>
<th>FIRSTGROUP</th>
<th>G4S</th>
<th>GLAXOSMITHKLINE</th>
<th>HAMMERSON</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reconciliation of derivative liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward foreign currency contracts</td>
<td>(3.7)</td>
<td>(15.0)</td>
<td>(19.0)</td>
<td>(0.5)</td>
<td>(13.6)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Forward commodity contracts
| Foreign exchange option contracts
| Other
| Cross currency swaps | (6.8)              |        |                  |                 |            |     |                 |           |
| Fuel derivatives
| Interest rate swaps | (3.0)              | (12.0) | (34.1)           | (0.1)           | (6.4)      |     |                 |           |
| Interest rate collars
| Equity contracts
| Embedded derivatives |
Information not presented disaggregated (current liabilities)

- Forward foreign exchange contracts and foreign exchange swaps (20.0)
- Commodity derivatives (futures, forwards, options [min/max])
  - Held for trading
  - Hedging instruments
  - Interest rate swaps and forward foreign exchange contracts
  - Swap and forward exchange contracts

Non-current liabilities

- Forward commodity contracts (40.0) (51.0)
- Other (13.0)
- Interest rate swaps (25.0) (27.8) (8.1)
- Forward currency contracts
- Cross currency swaps
- Fuel derivatives

Information not presented disaggregated (non-current liabilities)

- Currency derivatives
- Interest rate swaps and forward foreign exchange contracts
- Interest rate derivatives
- Commodity derivatives

Not possible to differentiate current from non-current

- Forward/future foreign currency contracts (260.0)
- Forward/future commodity contracts
- Commodity contracts - swaps, futures, options and forwards
- Other
- Cross currency swaps
- Interest rate swaptions (6.0)
- Equity collars, options and warrants (2.0)
- Embedded derivatives (2.0)
- Currency risks
- Market risks

<table>
<thead>
<tr>
<th>CARPHONE WAREHOUSE</th>
<th>DIAGEO</th>
<th>EURASIAN NATURAL</th>
<th>ENTERPRISE INNS</th>
<th>FIRSTGROUP</th>
<th>G4S</th>
<th>GLAXOSMITHKLINE</th>
<th>HAMMERSON</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(3.7)</td>
<td>(116.0)</td>
<td>(70.0)</td>
<td>(12.0)</td>
<td>(64.7)</td>
<td>(21.8)</td>
<td>(270.0)</td>
</tr>
<tr>
<td>Company name</td>
<td>HOME RETAIL GROUP</td>
<td>INTERCONT HOTELS</td>
<td>INTERNATIONAL POWER</td>
<td>ITV</td>
<td>JOHNSON MATTHEY PLC</td>
<td>KAZAKHMYS</td>
<td>KINGFISHER</td>
</tr>
<tr>
<td>------------------------------</td>
<td>-------------------</td>
<td>------------------</td>
<td>---------------------</td>
<td>-----</td>
<td>---------------------</td>
<td>-----------</td>
<td>------------</td>
</tr>
<tr>
<td>Year end</td>
<td>01.03.08</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>31.03.08</td>
<td>31.12.07</td>
<td>02.02.08</td>
</tr>
</tbody>
</table>

**Reconciliation of derivative assets**

**Current assets**

- Forward foreign currency contracts: 4.3, 4.0, 4.3
- Forward commodity contracts
- Foreign exchange option contracts
- Other
  - Cross currency swaps
  - Interest rate swaps: 1.3
  - Interest rate swaps: 12.6
- Fuel derivatives
- Embedded derivatives: 0.6

**Information not presented disaggregated (current assets)**

- Forward foreign exchange contracts and foreign exchange swaps: 4.1
- Commodity derivatives (futures, forwards, options [min/max])
- Forward foreign exchange contracts, forward currency options and interest rate swaps
- Held for trading
- Hedging instruments
- Interest rate swaps and forward foreign exchange contracts
- Currency and commodity contracts
- Swap and forward exchange contracts
- Foreign exchange derivatives
- Interest rate derivatives

**Non-current assets**

- Forward foreign currency contracts: 2.0
- Forward commodity contracts
- Equity instruments
- Other
  - Interest rate swaps: 30.0
- Cross currency swaps
- Fuel derivatives
Information not presented disaggregated (non-current assets)
Commodity derivatives (futures, forwards, options [min/max])
Currency derivatives
Interest rate swaps and forward foreign exchange contracts
Currency and commodity contracts
Interest rate derivatives

Not possible to differentiate current from non-current
Forward/future foreign currency contracts
Forward commodity contracts 208.0
Commodity contracts - swaps, futures, options and forwards
Other 22.0
Cross currency swaps
Interest rate swaps 30.0 13.0
Embedded derivatives
Hedges of net investments in foreign operations
Equity collars, options and warrants 30.0
Currency risks
Market risks

Reconciliation of derivative liabilities
Current liabilities
Forward foreign currency contracts (2.8) (1.0)
Forward commodity contracts
Foreign exchange option contracts
Other
Cross currency swaps (8.3)
Fuel derivatives
Interest rate swaps (2.0) (10.7)
Interest rate collars
Equity contracts
Embedded derivatives
### Information not presented disaggregated (current liabilities)

- Forward foreign exchange contracts and foreign exchange swaps
- Commodity derivatives (futures, forwards, options [min/max])
- Held for trading
- Hedging instruments
- Interest rate swaps and forward foreign exchange contracts
- Swap and forward exchange contracts
- Foreign exchange derivatives
- Interest rate derivatives

#### Non-current liabilities

- Forward commodity contracts
- Other
- Interest rate swaps
- Forward currency contracts
- Cross currency swaps
- Fuel derivatives

### Information not presented disaggregated (non-current liabilities)

- Currency derivatives
- Interest rate swaps and forward foreign exchange contracts
- Interest rate derivatives
- Commodity derivatives

### Not possible to differentiate current from non-current

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward/future foreign currency contracts</td>
<td>26.0</td>
</tr>
<tr>
<td>Forward/future commodity contracts</td>
<td>734.0</td>
</tr>
<tr>
<td>Commodity contracts - swaps, futures, options and forwards</td>
<td>0.0</td>
</tr>
<tr>
<td>Other</td>
<td>24.0</td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td>76.0</td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>0.0</td>
</tr>
<tr>
<td>Interest rate swaptions</td>
<td>26.0</td>
</tr>
<tr>
<td>Equity collars, options and warrants</td>
<td>0.0</td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td>26.0</td>
</tr>
<tr>
<td>Currency risks</td>
<td>0.0</td>
</tr>
<tr>
<td>Market risks</td>
<td>10.7</td>
</tr>
</tbody>
</table>

The table above shows the financial risks associated with various derivative instruments, categorized by their current or non-current status and their specific types, such as foreign exchange contracts, commodity derivatives, and others. The values indicate the exposure or potential impact of these financial instruments on the financial statements of the company.
## Reconciliation of derivative assets

### Current assets

<table>
<thead>
<tr>
<th>Description</th>
<th>LIBERTY INT</th>
<th>MARKS &amp; SPENCER</th>
<th>MORRISON SUPERMKTS</th>
<th>NATIONAL GRID</th>
<th>NEXT</th>
<th>PERSIMMON PLC</th>
<th>PEARSON</th>
<th>RECKITT BENCK GRP</th>
<th>ROYAL DUTCH SHELL</th>
<th>REED ELSEVIER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year end</td>
<td>31.12.07</td>
<td>29.03.08</td>
<td>03.02.08</td>
<td>31.03.08</td>
<td>26.01.08</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>31.12.07</td>
</tr>
</tbody>
</table>

- **Forward foreign currency contracts**: 12.6
- **Forward commodity contracts**: 6.0
- **Foreign exchange option contracts**: Other 12.4
- **Cross currency swaps**: Interest rate swaps
- **Fuel derivatives**: Embedded derivatives

### Information not presented disaggregated (current assets)

- **Forward foreign exchange contracts and foreign exchange swaps**
- **Commodity derivatives (futures, forwards, options [min/max])**
- **Forward foreign exchange contracts, forward currency options and interest rate swaps**
- **Held for trading**
- **Hedging instruments**
  - Interest rate swaps and forward foreign exchange contracts: 20.4
  - Currency and commodity contracts
  - Swap and forward exchange contracts
  - Foreign exchange derivatives
  - Interest rate derivatives

### Non-current assets

- **Forward foreign currency contracts**: 1.3
- **Forward commodity contracts**: Equity instruments 0.5
- **Other**
  - Interest rate swaps
  - Cross currency swaps: 16.9
  - Fuel derivatives
Information not presented disaggregated (non-current assets)

Commodity derivatives (futures, forwards, options [min/max])
Currency derivatives
Interest rate swaps and forward foreign exchange contracts 5.0
Currency and commodity contracts
Interest rate derivatives

Not possible to differentiate current from non-current
Forward/future foreign currency contracts 16.0 234.0 39.0
Forward commodity contracts
Commodity contracts - swaps, futures, options and forwards 17,931.0
Other 116.0 796.0
Cross currency swaps 43.0 1,246.0 26.0 927.0 155.0
Interest rate swaps 148.0 25.0 117.0 16.0
Embedded derivatives
Hedges of net investments in foreign operations
Equity collars, options and warrants
Currency risks
Market risks

Reconciliation of derivative liabilities
Current liabilities
Forward foreign currency contracts
Forward commodity contracts (22.7)
Foreign exchange option contracts
Other (12.4)
Cross currency swaps
Fuel derivatives
Interest rate swaps
Interest rate collars
Equity contracts (53.6)
Embedded derivatives
Information not presented disaggregated (current liabilities)

Forward foreign exchange contracts and foreign exchange swaps
Commodity derivatives (futures, forwards, options [min/max])
Held for trading
Hedging instruments
Interest rate swaps and forward foreign exchange contracts (3.8)
Swap and forward exchange contracts
Foreign exchange derivatives
Interest rate derivatives

Non-current liabilities
Forward commodity contracts
Other
Interest rate swaps
Forward currency contracts
Cross currency swaps
Fuel derivatives

Information not presented disaggregated (non-current liabilities)
Currency derivatives
Interest rate swaps and forward foreign exchange contracts (94.0)
Interest rate derivatives
Commodity derivatives

Not possible to differentiate current from non-current
Forward/future foreign currency contracts
Forward/future commodity contracts
Commodity contracts - swaps, futures, options and forwards (19,090.0)
Other (116.0)
Cross currency swaps (100.0) (68.0)
Interest rate swaps (184.0) (16.0) (1.0) (9.0)
Interest rate swaptions
Equity collars, options and warrants
Embedded derivatives
Currency risks
Market risks

<table>
<thead>
<tr>
<th></th>
<th>LIBERTY</th>
<th>MARKS &amp; SPENCER</th>
<th>MORRISON SUPERMKTS</th>
<th>NATIONAL GRID</th>
<th>NEXT</th>
<th>PERSIMMON PLC</th>
<th>RECKITT BENCK GRP</th>
<th>ROYAL DUTCH SHELL</th>
<th>REED ELSEVIER</th>
</tr>
</thead>
<tbody>
<tr>
<td>(97.8)</td>
<td>(35.1)</td>
<td>0.0</td>
<td>(433.0)</td>
<td>(67.3)</td>
<td>(68.0)</td>
<td>(16.0)</td>
<td>(6.0)</td>
<td>(20,637.0)</td>
<td>(22.0)</td>
</tr>
</tbody>
</table>
### Reconciliation of derivative assets

#### Current assets

<table>
<thead>
<tr>
<th></th>
<th>REXAM</th>
<th>TINTO</th>
<th>ROLLS-ROYCE GROUP</th>
<th>SABMILLER</th>
<th>SAIBNSURY</th>
<th>SHIRE</th>
<th>SMITH &amp; NEPHEW</th>
<th>SCOT &amp; STHN ENERGY</th>
<th>SEVERN</th>
<th>TATE &amp; LYLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year end</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>31.03.08</td>
<td>22.03.08</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>31.03.08</td>
<td>31.03.08</td>
<td>31.03.08</td>
</tr>
</tbody>
</table>

- **Forward foreign currency contracts**: 44.0  4.0  1.0  4.0
- **Forward commodity contracts**: 257.0
- **Foreign exchange option contracts**
- **Other**
- **Cross currency swaps**: 10.0
- **Interest rate swaps**: 1.0  4.0
- **Fuel derivatives**
- **Embedded derivatives**

#### Information not presented disaggregated (current assets)

- **Forward foreign exchange contracts and foreign exchange swaps**
- **Commodity derivatives (futures, forwards, options [min/max])**
- **Forward foreign exchange contracts, forward currency options and interest rate swaps**
- **Held for trading**
- **Hedging instruments**
- **Interest rate swaps and forward foreign exchange contracts**
- **Currency and commodity contracts**: 34.0
- **Swap and forward exchange contracts**: 8.2
- **Foreign exchange derivatives**
- **Interest rate derivatives**

#### Non-current assets

- **Forward foreign currency contracts**: 2.0  1.0
- **Forward commodity contracts**: 3.0  1.0
- **Equity instruments**
- **Other**
- **Interest rate swaps**: 39.0  121.0  10.0
- **Cross currency swaps**: 82.0  24.0
- **Fuel derivatives**
Information not presented disaggregated (non-current assets)
Commodity derivatives (futures, forwards, options [min/max])
Currency derivatives
Interest rate swaps and forward foreign exchange contracts
Currency and commodity contracts 580.0
Interest rate derivatives

Not possible to differentiate current from non-current
Forward/future foreign currency contracts 433.0
Forward commodity contracts 39.0
Commodity contracts - swaps, futures, options and forwards 1,389.8
Other 35.6
Cross currency swaps 166.0 52.8
Interest rate swaps 2.0 42.0 3.8
Embedded derivatives
Hedges of net investments in foreign operations
Equity collars, options and warrants
Currency risks
Market risks

Reconciliation of derivative liabilities

<table>
<thead>
<tr>
<th></th>
<th>REXAM</th>
<th>TINTO</th>
<th>ROLLS-ROYCE</th>
<th>SABMILLER</th>
<th>SAINSBURY</th>
<th>SHIRE</th>
<th>SMITH &amp; NEPHEW</th>
<th>SCOT &amp; STHN ENERGY</th>
<th>SEVERN</th>
<th>TATE &amp; LYLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward foreign currency contracts</td>
<td>(9.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward commodity contracts</td>
<td>(3.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange option contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate collars</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

168.0 653.0 514.0 253.0 4.0 8.2 1.0 1,425.4 56.6 311.0
### Information not presented disaggregated (current liabilities)

Forward foreign exchange contracts and foreign exchange swaps
Commodity derivatives (futures, forwards, options [min/max])
Held for trading
Hedging instruments
Interest rate swaps and forward foreign exchange contracts
Swap and forward exchange contracts
Foreign exchange derivatives
Interest rate derivatives

#### Non-current liabilities

<table>
<thead>
<tr>
<th></th>
<th>Rexam</th>
<th>Rio Tinto</th>
<th>Rolls-Royce Group</th>
<th>Sainsbury</th>
<th>Shire</th>
<th>Smith &amp; Nephew</th>
<th>Scott &amp; Sthn</th>
<th>Severn</th>
<th>Tate &amp; Lyle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward commodity contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>(6.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward currency contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td>(2.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Information not presented disaggregated (non-current liabilities)

Currency derivatives
Interest rate swaps and forward foreign exchange contracts
Interest rate derivatives
Commodity derivatives

#### Not possible to differentiate current from non-current

<table>
<thead>
<tr>
<th></th>
<th>Rexam</th>
<th>Rio Tinto</th>
<th>Rolls-Royce Group</th>
<th>Sainsbury</th>
<th>Shire</th>
<th>Smith &amp; Nephew</th>
<th>Scott &amp; Sthn</th>
<th>Severn</th>
<th>Tate &amp; Lyle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward/future foreign currency contracts</td>
<td>(54.0)</td>
<td>(1.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward/future commodity contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity contracts - swaps, futures, options and forwards</td>
<td>(1,492.3)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td>(488.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>(3.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaptions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity collars, options and warrants</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency risks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market risks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(12.0) (1,325.0) (57.0) (531.0) (24.0) (2.8) (23.0) (1,542.7) (82.7) (297.0)
<table>
<thead>
<tr>
<th>Company name</th>
<th>TULLOW OIL</th>
<th>THOMSON REUTERS</th>
<th>TESCO PLC</th>
<th>TUI TRAVEL</th>
<th>UNILEVER</th>
<th>UNITED UTILITIES</th>
<th>VEDANTA RESOURCES</th>
<th>VODAFONE GRP</th>
<th>WOOD GROUP (JOHN)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year end</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>23.02.08</td>
<td>31.12.07</td>
<td>31.12.07</td>
<td>31.03.08</td>
<td>31.03.08</td>
<td>31.03.08</td>
<td>31.12.07</td>
</tr>
</tbody>
</table>

### Reconciliation of derivative assets

#### Current assets

<table>
<thead>
<tr>
<th></th>
<th>TULLOW OIL</th>
<th>THOMSON REUTERS</th>
<th>TESCO PLC</th>
<th>TUI TRAVEL</th>
<th>UNILEVER</th>
<th>UNITED UTILITIES</th>
<th>VEDANTA RESOURCES</th>
<th>VODAFONE GRP</th>
<th>WOOD GROUP (JOHN)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward foreign currency contracts</td>
<td>1.0</td>
<td>9.2</td>
<td>0.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward commodity contracts</td>
<td></td>
<td>35.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange option contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Information not presented disaggregated (current assets)

- Forward foreign exchange contracts and foreign exchange swaps
- Commodity derivatives (futures, forwards, options [min/max])
- Forward foreign exchange contracts, forward currency options and interest rate swaps
- Held for trading
- Hedging instruments
- Interest rate swaps and forward foreign exchange contracts
- Currency and commodity contracts
- Swap and forward exchange contracts
- Foreign exchange derivatives | 377.0
- Interest rate derivatives | 99.0

#### Non-current assets

<table>
<thead>
<tr>
<th></th>
<th>TULLOW OIL</th>
<th>THOMSON REUTERS</th>
<th>TESCO PLC</th>
<th>TUI TRAVEL</th>
<th>UNILEVER</th>
<th>UNITED UTILITIES</th>
<th>VEDANTA RESOURCES</th>
<th>VODAFONE GRP</th>
<th>WOOD GROUP (JOHN)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward foreign currency contracts</td>
<td></td>
<td>79.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward commodity contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity instruments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross currency swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Information not presented disaggregated (non-current assets)
Commodity derivatives (futures, forwards, options [min/max])
Currency derivatives
Interest rate swaps and forward foreign exchange contracts
Currency and commodity contracts
Interest rate derivatives

Not possible to differentiate current from non-current
Forward/future foreign currency contracts
Forward commodity contracts
Commodity contracts - swaps, futures, options and forwards
Other
Cross currency swaps
Interest rate swaps
Embedded derivatives
Hedges of net investments in foreign operations
Equity collars, options and warrants
Currency risks
Market risks

Reconciliation of derivative liabilities
Current liabilities
Forward foreign currency contracts
Forward commodity contracts
Foreign exchange option contracts
Other
Cross currency swaps
Fuel derivatives
Interest rate swaps
Interest rate collars
Equity contracts
Embedded derivatives
## Information not presented disaggregated (current liabilities)

- Forward foreign exchange contracts and foreign exchange swaps
- Commodity derivatives (futures, forwards, options [min/max])
- Hedging instruments
- Interest rate swaps and forward foreign exchange contracts
- Swap and forward exchange contracts

### Hedging instruments

- Foreign exchange derivatives
- Interest rate derivatives

### Non-current liabilities

- Forward commodity contracts
- Other
- Interest rate swaps
- Forward currency contracts
- Cross currency swaps
- Fuel derivatives

## Information not presented disaggregated (non-current liabilities)

- Currency derivatives
- Interest rate swaps and forward foreign exchange contracts
- Interest rate derivatives
- Commodity derivatives

## Not possible to differentiate current from non-current

- Forward/future foreign currency contracts
- Forward/future commodity contracts
- Commodity contracts - swaps, futures, options and forwards
- Other
- Cross currency swaps
- Interest rate swaps
- Interest rate swaptions
- Equity collars, options and warrants
- Embedded derivatives

### Currency risks

<table>
<thead>
<tr>
<th></th>
<th>TULLOW OIL</th>
<th>THOMSON REUTERS</th>
<th>TESCO PLC</th>
<th>TUI TRAVEL</th>
<th>UNILEVER</th>
<th>UNITED UTILITIES</th>
<th>VEDANTA RESOURCES</th>
<th>VODAFONE GRP</th>
<th>WOOD GROUP (JOHN)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>(158.0)</td>
<td>(31.0)</td>
<td>(765.0)</td>
<td>(300.8)</td>
<td>(157.0)</td>
<td>(189.9)</td>
<td>(107.0)</td>
<td>(544.0)</td>
<td>(2.7)</td>
</tr>
</tbody>
</table>
Reconciliation of derivative assets

Current assets
Forward foreign currency contracts 5.5  1.0
Forward commodity contracts 3.0
Foreign exchange option contracts
Other
Cross currency swaps
Interest rate swaps 4.0
Fuel derivatives
Embedded derivatives

Information not presented disaggregated (current assets)
Forward foreign exchange contracts and foreign exchange swaps
Commodity derivatives (futures, forwards, options [min/max])
Forward foreign exchange contracts, forward currency options and interest rate swaps
Held for trading
Hedging instruments
Interest rate swaps and forward foreign exchange contracts
Currency and commodity contracts
Swap and forward exchange contracts
Foreign exchange derivatives 81.0
Interest rate derivatives

Non-current assets
Forward foreign currency contracts 112.0
Forward commodity contracts
Equity instruments
Other
Interest rate swaps 22.7  98.0
Cross currency swaps
Fuel derivatives
Information not presented disaggregated (non-current assets)
Commodity derivatives (futures, forwards, options [min/max])
Currency derivatives 50.3
Interest rate swaps and forward foreign exchange contracts
Currency and commodity contracts
Interest rate derivatives

Not possible to differentiate current from non-current
Forward/future foreign currency contracts
Forward commodity contracts
Commodity contracts - swaps, futures, options and forwards
Other
Cross currency swaps
Interest rate swaps
Embedded derivatives
Hedges of net investments in foreign operations
Equity collars, options and warrants
Currency risks
Market risks

Reconciliation of derivative liabilities
Current liabilities
Forward foreign currency contracts
Forward commodity contracts
Foreign exchange option contracts
Other
Cross currency swaps
Fuel derivatives
Interest rate swaps (1.8)
Interest rate collars
Equity contracts
Embedded derivatives
Information not presented disaggregated (current liabilities)

Forward foreign exchange contracts and foreign exchange swaps
Commodity derivatives (futures, forwards, options [min/max]) (205.0)
Held for trading
Hedging instruments
Interest rate swaps and forward foreign exchange contracts
Swap and forward exchange contracts
Foreign exchange derivatives
Interest rate derivatives

Non-current liabilities
Forward commodity contracts
Other Forward currency contracts Cross currency swaps Fuel derivatives

Information not presented disaggregated (non-current liabilities)
Currency derivatives (57.5) (142.0)
Interest rate swaps and forward foreign exchange contracts
Interest rate derivatives (22.3)
Commodity derivatives (58.0)

Not possible to differentiate current from non-current
Forward/future foreign currency contracts
Forward/future commodity contracts
Commodity contracts - swaps, futures, options and forwards
Other Cross currency swaps Interest rate swaps Interest rate swaptions Equity collars, options and warrants Embedded derivatives Currency risks Market risks

(79.8) (9.4) (411.0)
## Appendix B Summary of disclosure compliance for a randomly selected company in the sample

Note: 1 = fully compliant with requirement; 0 = not compliant with requirement; N/A = requirement compliance not necessary

### BALANCE SHEET

#### Categories of financial assets and financial liabilities

<table>
<thead>
<tr>
<th>7.8 (a) i.</th>
<th>7.8 (a) ii.</th>
<th>7.8 (b)</th>
<th>7.8 (c)</th>
<th>7.8 (d)</th>
<th>7.8 (e) i.</th>
<th>7.8 (e) ii.</th>
<th>7.8 (f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1</td>
<td>N/A</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

#### FAs and FLs at FV thru P/L

<table>
<thead>
<tr>
<th>7.9 (a)</th>
<th>7.9 (b)</th>
<th>7.9 (c)</th>
<th>7.9 (d)</th>
<th>7.10 (a)</th>
<th>7.10 (b)</th>
<th>7.11 (a)</th>
<th>7.11 (b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1</td>
<td>1</td>
<td>N/A</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>N/A</td>
</tr>
</tbody>
</table>

#### Reclassification

<table>
<thead>
<tr>
<th>7.12 (a)</th>
<th>7.12 (b)</th>
<th>7.12 descr</th>
<th>7.13 (a)</th>
<th>7.13 (b)</th>
<th>7.13 (c)</th>
<th>7.13 (d)</th>
<th>7.14 (a)</th>
<th>7.14 (b)</th>
<th>7.15 (a)</th>
<th>7.15 (b)</th>
<th>7.15 (c)</th>
</tr>
</thead>
<tbody>
<tr>
<td>N/A</td>
<td>0</td>
<td>0</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

#### Derecognition

<table>
<thead>
<tr>
<th>7.16</th>
<th>7.17</th>
<th>7.18 (a)</th>
<th>7.18 (b)</th>
<th>7.18 (c)</th>
<th>7.19</th>
</tr>
</thead>
<tbody>
<tr>
<td>N/A</td>
<td>1</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>
# INCOME STATEMENT AND EQUITY

<table>
<thead>
<tr>
<th>Items of income, expense, gains and losses</th>
<th>Sample company</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.20 (a) i.</td>
<td>1</td>
</tr>
<tr>
<td>7.20 (a) ii.</td>
<td>1</td>
</tr>
<tr>
<td>7.20 (a) iii.</td>
<td>N/A</td>
</tr>
<tr>
<td>7.20 (a) iv.</td>
<td>1</td>
</tr>
<tr>
<td>7.20 (a) v.</td>
<td>1</td>
</tr>
<tr>
<td>7.20 (b)</td>
<td>N/A</td>
</tr>
<tr>
<td>7.20 (c) i.</td>
<td>N/A</td>
</tr>
<tr>
<td>7.20 (c) ii.</td>
<td>N/A</td>
</tr>
<tr>
<td>7.20 (d)</td>
<td>N/A</td>
</tr>
<tr>
<td>7.20 (e)</td>
<td>1</td>
</tr>
</tbody>
</table>

# OTHER DISCLOSURES

## Accounting policies

<table>
<thead>
<tr>
<th>Sample company</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.85 (a) i.</td>
</tr>
<tr>
<td>7.85 (a) ii.</td>
</tr>
<tr>
<td>7.85 (a) iii.</td>
</tr>
<tr>
<td>7.85 (b)</td>
</tr>
<tr>
<td>7.85 (c)</td>
</tr>
<tr>
<td>7.85 (d) i.</td>
</tr>
<tr>
<td>7.85 (d) ii.</td>
</tr>
<tr>
<td>7.85 (e)</td>
</tr>
<tr>
<td>7.85 (f)</td>
</tr>
<tr>
<td>7.85 (g)</td>
</tr>
</tbody>
</table>

## Hedge accounting

<table>
<thead>
<tr>
<th>Sample company</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.22 (a)</td>
</tr>
<tr>
<td>7.22 (b)</td>
</tr>
<tr>
<td>7.22 (c)</td>
</tr>
<tr>
<td>7.23 (a)</td>
</tr>
<tr>
<td>7.23 (b)</td>
</tr>
<tr>
<td>7.23 (c)</td>
</tr>
<tr>
<td>7.23 (d) i.</td>
</tr>
<tr>
<td>7.23 (d) ii.</td>
</tr>
<tr>
<td>7.24 (a) i.</td>
</tr>
<tr>
<td>7.24 (a) ii.</td>
</tr>
<tr>
<td>7.24 (b)</td>
</tr>
<tr>
<td>7.24 (c)</td>
</tr>
</tbody>
</table>

## Fair value

<table>
<thead>
<tr>
<th>Sample company</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.25</td>
</tr>
<tr>
<td>7.27 (a)</td>
</tr>
<tr>
<td>7.27 (b)</td>
</tr>
<tr>
<td>7.27 (c)</td>
</tr>
<tr>
<td>7.27 (d)</td>
</tr>
<tr>
<td>7.27 (c)</td>
</tr>
<tr>
<td>7.28 (a)</td>
</tr>
<tr>
<td>7.28 (b)</td>
</tr>
<tr>
<td>7.29 (a)</td>
</tr>
<tr>
<td>7.29 (b)</td>
</tr>
<tr>
<td>7.29 (c)</td>
</tr>
<tr>
<td>7.30 (a)</td>
</tr>
<tr>
<td>7.30 (b)</td>
</tr>
<tr>
<td>7.30 (c)</td>
</tr>
<tr>
<td>7.30 (d)</td>
</tr>
<tr>
<td>7.30 (e)</td>
</tr>
</tbody>
</table>
## NATURE AND EXTENT OF RISKS ARISING FROM FINANCIAL INSTRUMENTS

<table>
<thead>
<tr>
<th></th>
<th>Qualitative disclosures</th>
<th>Quant disc</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Objs</td>
<td>Pols</td>
</tr>
<tr>
<td><strong>Credit</strong></td>
<td>7.33 (a)</td>
<td>7.33 (b)</td>
</tr>
<tr>
<td>Sample company</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Qualitative disclosures</th>
<th>Quant disc</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Objs</td>
<td>Pols</td>
</tr>
<tr>
<td><strong>Liq'y</strong></td>
<td>7.33 (a)</td>
<td>7.33 (b)</td>
</tr>
<tr>
<td>Sample company</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Qualitative disclosures</th>
<th>Quant disc</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Objs</td>
<td>Pols</td>
</tr>
<tr>
<td><strong>Market</strong></td>
<td>7.33 (a)</td>
<td>7.33 (b)</td>
</tr>
<tr>
<td>Sample company</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Concentrations of risk</td>
<td>Credit risk</td>
<td></td>
</tr>
<tr>
<td>------------------------</td>
<td>-------------</td>
<td></td>
</tr>
<tr>
<td>7.34 (c) 1 7.34 (c) 2 7.34 (c) 3 7.35</td>
<td>7.36 (a) 7.36 (b) 7.36 (c) 7.36 (d)</td>
<td></td>
</tr>
<tr>
<td>1 1 1 N/A</td>
<td>1 N/A 1 N/A</td>
<td></td>
</tr>
<tr>
<td>Sample company</td>
<td>1 1 1 N/A</td>
<td></td>
</tr>
<tr>
<td>7.37 (a) 7.37 (b) 7.37 (c) 7.38 (a) 7.38 (b)</td>
<td>N/A N/A N/A N/A</td>
<td></td>
</tr>
<tr>
<td>Sample company</td>
<td>1 1 N/A N/A</td>
<td></td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>7.39 (a) 7.811 7.812 7.813</td>
<td></td>
</tr>
<tr>
<td>1 1 1 1</td>
<td>1 1 1 1</td>
<td></td>
</tr>
<tr>
<td>Sample company</td>
<td>1 1 N/A</td>
<td></td>
</tr>
<tr>
<td>Market risk (incl sensitivity analysis)</td>
<td>7.40 (a) 7.40 (b) 7.40 (c) 7.41</td>
<td></td>
</tr>
<tr>
<td>1 1 N/A N/A</td>
<td>7.41 (a) 7.41 (b) 7.42</td>
<td></td>
</tr>
<tr>
<td>Sample company</td>
<td>N/A N/A N/A</td>
<td></td>
</tr>
<tr>
<td>Early adoption</td>
<td>7.43 7.44</td>
<td></td>
</tr>
<tr>
<td>Exemption</td>
<td>N/A N/A</td>
<td></td>
</tr>
<tr>
<td>Sample company</td>
<td>N/A N/A</td>
<td></td>
</tr>
</tbody>
</table>

Page 410
Appendix C: An overview of the application of the investigatory conceptual framework (figure 1)

The original proposition of disclosure research is that a full disclosure position is optimal where the disclosures themselves are costless, feasible and credible (e.g. Dye, 1985, 1986; Verrecchia, 1983, 1990; Darrough and Stoughton, 1990). Ultimately, as put forward by early research in this area, full transparent disclosure seeks to offset any potential for adverse selection that would arise from non-, or a lack of, information provision (Grossman, 1981; Milgrom, 1981).

The first of these propositions that was challenged by Dye (1986) was whether full disclosure of credible proprietary information would meet with full compliance. The evidence put forward by Dye (1986) suggested that partial disclosure could be the optimum disclosure decision if this meant releasing proprietary information even if that same information was credible. Therefore, the starting point of this framework was adopted from this observation. In all cases of partial or non-compliance the disclosure itself (and the associated issue) was examined and the researcher addressed whether the information that had been excluded might serve to reduce the present value of the cash flows of the entity given the public disclosure of that information. In itself this might be the rationale for partial or non-disclosure but it is prudent to ask further questions to either build on, challenge or corroborate this judgement. For example, in each of the results sections that follow the first question considered is whether this information is costly - issues such as reclassifications, defaults and breaches, fair value disclosures and sensitivity analysis are thought to be proprietary whilst other issues – normally those based on common sense – such as accounting policies for an allowance account are most likely not. Thus, different reasons for non- or partial disclosure emerge.

The next question addressed was the issue of a disclosure equilibrium and the pressures on management to disclose or withhold information based upon a cost versus benefit equation (e.g. Eisenhardt, 1989; Suijs, 2005). Prior work has argued that if the costs of proprietary information disclosure outweigh the benefits then full disclosure is unlikely to be met (Dye, 1985). There are various ways to measure this and thus it is timely to note that at each stage there is a level of subjectivity to the
analysis. Therefore, in an attempt to reduce the risks associated with the use of judgement, supplementary evidence was sought from either academic or professional sources and from interview evidence with the aim of substantiating any conclusions drawn.

If, on the balance of evidence, it was thought that the costs outweighed the benefits then the following question was whether there was an externality (either real or financial) driving the production of the information. Dye (1990) argued that an externality could act as the force behind the release of private information. In the absence of any interest from an external source then there will be no disclosure made. If there is evidence of an external, then prior work has argued that either full or modified disclosure might be the optimum position (Dye, 1990; Combes-Thuelin et al., 2006). It is possible, for example, that the disclosure of the technical default by International Power arose as a result of this pressure.

The next issue is whether there is the likelihood of audit oversight. As the findings sections show, there are cases where omitted disclosures probably do result from preparer error and subsequent audit oversight but the interview evidence, survey data, comment letter responses and professional articles tend to suggest that these disclosure areas are immaterial, non-essential or would lack credibility or feasibility. The most obvious example from this project was the poor compliance with the disclosure of the assumptions underlying the sensitivity analysis. As argued by comment letter respondents, in most cases this is sensitive information and has the potential to reduce the present value of future cash flows but it lacks the grounding in real economic factors. Though one needs to be careful not to over-generalise, it would seem a fair and reasonable conclusion - from the evidence both here and from past research - to suggest that under duress from an external party an entity might meet the requirements fully (e.g. Dye, 1990; Combes-Thuelin et al., 2006). However, without this pressure, interviewees believed (as will be discussed) that – given the

---

198 Evidence from both this work and prior (e.g. Holland, 1998; 2005) suggests that the externality drives disclosure through private channels e.g. one-to-one meetings rather than necessarily at this public mandatory level.

199 For example comment letter respondents and interviewees consistently make reference to the lack of timeliness and thus the fact this information is useless at the point of reading. Derivatives positions are fluid and it is highly unlikely an entity will be exposed to the same levels of risks and volume of instruments three months after the year end.
sensitive nature of this information, its cost to produce and its lack of credibility – if others in the market weren’t disclosing this information in their annual report, then they wouldn’t either. Due to the significant levels of dissatisfaction with the disclosure requirements (see comment letter analysis, survey and interview responses) it was relatively predictable that there would be high levels of partial or non-compliance for these requirements. Also, due to the lack of usefulness of this information and the fact that this information could be better sourced elsewhere for analysts, this lack of compliance was overlooked.

Returning to the question of whether this was picked up by the entity’s auditors it is necessary to state that within this sample of entities no audit report contained reference to financial instruments disclosures. Therefore, where issues were material and disclosure was not made, audit oversight is the most likely conclusion and no further investigation is required.200

If the cost equilibrium swung towards the rational decision being to make the disclosure then the question posed was whether the disclosure was feasible and credible. One reason put forward by certain researchers about why disclosure is made is the close link to reputation and a quality-signal approach (e.g. Hasseldine et al., 2005; Toms, 2002). However, if the disclosure is not credible or feasible then it is unlikely to be met (e.g. sensitivity analysis disclosures discussed above). The evidence suggests that disclosures of this type will only serve to be value destructive and managers would prefer not to make disclosures if they know they aren’t credible.

Prior work has highlighted the lack of reliability of fair value disclosures (Nissim, 2003). The framework for this project encourages one to ask the relevance and usefulness questions. The research undertaken shows that many stakeholders thought that many of the disclosures were not useful or relevant. For example, several interviewees and comment letter respondents made particular criticisms of some of the fair value disclosures (and the recognition and measurement of fair value) claiming they lacked usefulness or, in some cases, argued they were simply

200 Though no further investigation is required at this stage, certain speculations over rationale can be made on the basis that some entities comply whilst others don’t despite sharing many of the same characteristics.
asking for information that would be meaningless. If it was deemed there was a lack
of relevance or use to the disclosure then it could be argued that this was a likely
explanation for the exclusion of the information.

However, where disclosure was proprietary in nature, the benefits outweighed the
costs, it was credible and feasible and (on the basis of evidence) was judged to be
useful and relevant then preparation error was considered. One example might be
Enterprise Inn’s omittance of the collateral narrative. As discussed in section 4.4.2
this could be sensitive information but given the disclosure of the quantitative
information then this is most likely not to be a deliberate withholding of information
and thus preparation error and audit oversight are likely rationales.

In other cases however, the competition sensitive nature of information might drive
partial or non-disclosure (e.g. Barry and Brown, 1985, 1986; Merton, 1987; Healy
and Palepu, 1993, 1995). Where this is the case then it is likely that partial
compliance will arise. There were several occasions where information was deemed
to be sensitive and withheld (e.g. allowance account; collateral pledged; fair values).
In these instances further explanations needed to be sought. As disclosure decisions
(particularly those surrounding partial or non-compliance) are private then these
explanations are by default based upon subjective judgements. However, as stated
above, where possible these speculations have been triangulated with other data to
lend some credibility to the conclusions.

Finally, if the information requirements are met, the final question is whether they
have been exceeded. This question of ‘over compliance’ is considered further in
chapter 5.

To conclude this discussion, a brief discussion of the application of this framework is
provided below. The discussion is based around the disclosure compliance checklist
for one company as presented in appendix B. There are several compliance issues
here and these are examined below:

a) Reclassification non-compliance (IFRS 7.12)
   Question 1: Is this proprietary information?
Response: Yes
Question 2: Do the costs of producing the information outweigh the negative effects?
Response: Unlikely (somewhat subjective - no direct evidence other than high levels of compliance by other similar entities and no issues raised regarding the costs of disclosing this information through the comment letter process).
Question 3: Is there evidence that this lacks relevance or usefulness?
Response: Likely (subjective - limited interview evidence to support; partial disclosure made)
Question 4: Is audit error likely?
Response: Yes

b) Non-disclosure of accounting policies in respect to financial assets or liabilities classified as at fair value through profit or loss (specifically the nature of the assets/liabilities; and the criteria for so designating such financial assets or financial liabilities on initial recognition).

Question 1: Is this proprietary information?
Response: No – the disclosure of this information will not serve to reduce the present value of future cash flows.
Question 2: Is there an indication of financial statement preparation error?
Response: Yes
Question 3: Is audit error likely?
Response: Yes

Note: Follow up questions would be required if the entity carried a material volume or value of financial instruments classified as fair value through profit or loss. An attempt to locate a rationale for non-disclosure could be investigated by reviewing any information available specifically about the entity in question from the press or professional commentators; other information from the annual reports that would highlight sensitivity to the release of this information. The information would seek to explore whether this was deliberate omittance or simply an oversight.
c) Non-disclosure of accounting policies in respect to the criteria for designating financial assets as available for sale

Question 1: Is this proprietary information?
Response: Unlikely (there is the potential for this to be proprietary dependent upon future disclosure decisions and the possibility for reclassification of assets into and out of this category. Therefore, follow through both pathways i.e. ‘yes’ and ‘no’ in an attempt to establish rationale).

Question 2: Do the costs of producing the information outweigh the negative effects?
Response: No (subjective – several entities have not fully met this requirement and thus one is slightly suspicious that there is an underlying economic or social rationale for why this is withheld).

Question 3: Is there evidence that this lacks relevance or usefulness?
Response: Dependent upon materiality, no (the classifications of financial instruments and the processes and procedures are straightforward but this does not mean that this information is irrelevant or not useful especially that the accounting policies note should contain ‘significant accounting policies’. However, further investigation into the value of these assets was undertaken and in some cases they were immaterial in value (in the current and prior years) and therefore this disclosure would probably be irrelevant to this period’s annual report).

Question 4: Is preparation error likely?
Response: Yes

Question 5: Is audit error likely?
Response: Yes

To establish that this is the most likely rationale follow-up questions about whether this is sensitive information were also asked. In this case, the answer is ‘no’ but full compliance is not provided and therefore error and oversight are the most likely explanation.
Appendix D: IFRS 7 Disclosure checklist

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

7.7

BALANCE SHEET

Categories of financial assets and financial liabilities

The carrying amounts of each of the following categories, as defined in IAS 39, shall be disclosed either on the face of the balance sheet or in the notes:

7.8 (a) financial assets at fair value through profit or loss, showing separately:

i. those designated as such upon initial recognition; and

ii. those classified as held for trading in accordance with IAS 39;

7.8 (b) held-to-maturity investments;

7.8 (c) loans and receivables;

7.8 (d) available-for-sale assets;

7.8 (e) financial liabilities at fair value through profit or loss, showing separately:

i. those designated as such upon initial recognition; and

ii. those classified as held for trading in accordance with IAS 39;

7.8 (f) financial liabilities measured at amortised cost.

Financial assets or liabilities at fair value through profit or loss
The following FOUR disclosure requirements are contingent upon a positive response to the following statement (note: a negative response means that they should be marked N/A).

If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it shall disclose:

7.9 (a) the maximum exposure to credit risk of the loan or receivable at the reporting date;

Note: The maximum exposure to credit risk reported should not take account of any collateral held or other credit enhancements (e.g. netting agreements that do not qualify for offset in accordance with IAS 32 (see also IFRS 7.B9 and B10)

7.36 (a)

7.9 (b) the amount by which any related credit derivatives or similar instruments mitigates that maximum exposure to credit risk;

7.9 (c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable that is attributable to changes in the credit risk of the financial asset determined either:

i. as the amount of change in its FV that is not attributable to changes in market conditions that give rise to market risk; or

ii. Using an alternative method the entity believes more faithfully represents the amount of change in its FV that is attributable to changes in the credit risk of the asset.

Note: Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

7.9 (d) the amount of the change in the FV of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.
The following TWO disclosure requirements are contingent upon a positive response to the following statement (note: a negative response means that they should be marked N/A).

If the entity has designated a financial liability as at FV through Profit or loss in accordance with para 9 of IAS 39, it shall disclose:

7.10 (a) the amount of change, during the period and cumulatively, in the FV of the financial liability is attributable to changes in the credit risk of that liability determined either:

   i. as the amount of change in its FV that is not attributable to changes in market conditions that give risk to market risk (see IFRS 7.B4); or

   ii. Using an alternative method the entity believes more faithfully represents the amount of change in its FV that is attributable to changes in the credit risk of the liability.

Note: Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity’s financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

7.10 (b) the difference between the financial liability’s carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

If the entity was required to provide a response to 9(c) or 10(a) due to holding a loan or receivable at fair value through profit or loss or having designated a financial liability as at fair value through profit or loss then requirement 7.11(a) requires a response. Requirement 7.11(b) is also linked but is conditional upon a belief that the disclosure does not faithfully represent a change in the fair value (if this belief does not exist there should be no disclosure and therefore the checklist should be marked n/a).
The entity shall disclose:

(a) the methods used to determine the amount of change that is attributable to changes in the credit risk in compliance with the requirements in paragraphs 9(c) and 10(a) of IFRS 7

(b) if the entity believes that the disclosure it has given to comply with the requirements in para 9(c) or 10(a) of IFRS 7 does not faithfully represent the change in the FV of the financial asset or liability attributable to changes in credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

Reclassification

The following THREE disclosure requirements are contingent upon a positive response to the following statement (note: a negative response means that they should be marked N/A).

The amount reclassified into and out of each category should be disclosed if the entity has reclassified a financial asset as one measured:

(a) at cost or amortised cost, rather than at fair value; or

(b) at FV rather that at cost or amortised cost, it shall also the reason for that reclassification.

Derecognition

The following FOUR disclosure requirements are contingent upon a positive response to the following statement (note: a negative response means that they should be marked N/A).

An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition. The entity shall disclose for each class of such financial assets:

(a) the nature of the assets;
(a) the nature of the risks and rewards of
ownership to which the entity remains
exposed;

(b) when the entity continues to recognise all
of the assets, the carrying amounts of the
assets and of the associated liabilities; and

(d) when the entity continues to recognise the
assets to the extent of its continuing
involvement of the original assets, the amount
of the assets that the entity continues to
recognise, and the carrying amount of the
associated liabilities.

Collateral

The following TWO disclosure requirements
are contingent upon a positive response to
the following statement (note: a negative
response means that they should be marked N/A).

An entity shall disclose:

(a) the carrying amount of financial assets it
has pledged as collateral for liabilities or
contingent liabilities, including amounts that
have been reclassified in the balance sheet
separately from other assets as the transferee
has the right to sell or repledge the collateral.

(b) the terms and conditions relating to the
pledge.

The following THREE disclosure
requirements are contingent upon a positive
response to the following statement (note: a
negative response means that they should be marked N/A).

When an entity holds collateral (of financial or
non-financial assets) and is permitted to sell
or repledge the collateral in the absence of
default by the owner of the collateral, it shall
disclose:

(a) the FV of the collateral held;
(b) the FV of any such collateral sold or repledged, and whether the entity has an obligation to return it; and

(c) the terms and conditions associated with its use of the collateral.

**Allowance account for credit losses**

When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g. an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.

**Compound financial instruments with multiple embedded derivatives**

If an entity has issued an instrument that contains both a liability and an equity component and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.

**Defaults and breaches**

The following THREE disclosure requirements are contingent upon whether the entity recognises or has recognised any loans payable as in default.

For loans payable recognised at the reporting date, an entity shall disclose:

(a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;

(b) the carrying amount of the loans payable in default at the reporting date; and

(c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.
If, during the period, there were breaches of loan agreement terms other than those described in para 18 of IFRS 7 (see above) an entity shall disclose the same information as required by para 18 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date).

7.19

**INCOME STATEMENT AND EQUITY**

**Items of income, expense, gains or losses**

An entity shall disclose the following items of income, expense, gains or losses either on the face of the financial statements or in the notes:

7.20

(a) net gains or net losses on:

i. financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held for trading;

ii. Available-for-sale financial assets, showing separately the amount of gain or loss recognised directly in equity during the period and the amount removed from equity and recognised in profit or loss for the period;

iii. Held-to-maturity investments;

iv. Loans and receivables; and

v. financial liabilities measured at amortised cost;

(b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss;

7.20

(c) fee income and expense (other than amounts included in determining the effective
interest rate) arising from:

i. financial assets or financial liabilities that are not at fair value through profit or loss; and

ii. Trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.

7.20
(d) accrued interest income on impaired financial assets; and

(e) the amount of any impairment loss for each class of financial asset.

OTHER DISCLOSURES

Accounting policies

In accordance with para 108 of IAS 1, an entity discloses, in the summary of significant accounting policies the basis (or bases) used in preparing financial statements and the other accounting policies used that are relevant to an understanding of the financial statements, including:

Note: the following THREE disclosures are contingent upon the entity having designated financial assets or financial liabilities designated as at fair value through profit or loss

7.B5
(a) for financial assets or financial liabilities designated as at FV through profit or loss:

i. the nature of the financial assets or financial liabilities the entity has designated as at FV through profit or loss;

ii. The criteria for so designating such financial assets or financial liabilities on initial recognition; and

ii. How the entity has satisfied the conditions for such designation including where appropriate a narrative description of the circumstances underlying the measurement or recognition inconsistency that would otherwise arise, or how
designation at FV through profit or loss is consistent with the entity's documented risk management or investment strategy.

7.B5 (b) the criteria for designating financial assets as available for sale

7.B5 (c) whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date.

Note: the following TWO disclosures are contingent upon the entity maintaining an allowance account to reduce the carrying amount of financial assets impaired by credit losses

when an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses:

i. the criteria for determining when the carrying amount of impaired financial assets is reduced directly (or, in the case of a reversal of a write-down, increased directly) and when the allowance account is used; and

ii. The criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets

how net gains or net losses on each category of financial instrument are determined, for example, whether the net gains or net losses, on items at FV through profit or loss include interest or dividend income.

7.B5 (d) the criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred

when the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy for financial assets that are the subject of renegotiated terms.
Note: Para 113 of IAS 1 also requires entities to disclose the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have made a significant effect on the amounts recognised in its financial statements.

**Hedge Accounting**

Note: if an entity has not engaged with any form of hedge accounting then disclosures 7.22 through 7.24 (inclusive) are not applicable. The FIVE disclosures at 7.23 are contingent upon whether the entity holds any financial assets or liabilities or other contracts under cash flow hedge accounting relationships whilst the FOUR disclosures at 7.24 are contingent upon whether the entity holds any financial assets or liabilities or other contracts under fair value hedge accounting relationships.

An entity shall disclose the following separately for each type of hedge:

<table>
<thead>
<tr>
<th>7.22</th>
<th>(a) a description of each type of hedge; R-S</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.22</td>
<td>(b) a description of the financial instruments designated as hedging instruments and their FV at the reporting date; R-H</td>
</tr>
<tr>
<td>7.22</td>
<td>(c) the nature of the risks being hedged. R-S</td>
</tr>
</tbody>
</table>

For **cash flow** hedges, an entity shall disclose:

<table>
<thead>
<tr>
<th>7.23</th>
<th>(a) the periods when the cash flows are expected to occur and when they are expected to affect profit or loss; R-H</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.23</td>
<td>(b) a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur; R-S</td>
</tr>
<tr>
<td>7.23</td>
<td>(c) the amount that was recognised in equity during the period; R-H</td>
</tr>
</tbody>
</table>
(d) the amount that was removed from equity and included in profit or loss for the period showing the amount included in each line item in the income statement; and

(e) the amount that was removed from equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probably forecast transaction.

An entity shall disclose separately:

7.24 (a) in fair value hedges, gains or losses:

i. on the hedging instrument; and

ii. on the hedged item attributable to the hedged risk;

(b) the ineffectiveness recognised in profit or loss that arises from cash flow hedges; and

(c) the ineffectiveness recognised in profit or loss that arises from hedges of net investments in foreign operations.

Fair Value

Except as set out in para 29 of IFRS 7 (see below), for each class of financial assets and financial liabilities, an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

Note: In disclosing FVs, an entity shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the balance sheet.

An entity shall disclose:

(a) the methods and, when a valuation technique is used, the assumptions applied in determining FVs of each class of financial assets or financial liabilities.
Note: for example, if applicable, an entity discloses information about the assumption relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates.

7.27 (b) whether FVs are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation.

(c) whether the FVs recognised or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (i.e. without modification or repackaging) and not based on available observable market data;

(d) if para 27(c) of IFRS 7 applies, the total amount of the change in FV estimated using such a valuation technique that was recognised in profit or loss during the period.

In the circumstances described in para 27 (c) of IFRS 7 (see above), for FVs that are recognised in the F/S, if changing one or more of those assumptions to reasonable possible alternative assumptions would change fair value significantly, the entity shall state this fact and disclose the effect of those changes.

Note: For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in FV are recognised in equity, total equity.

If a difference exists between the FV at initial recognition and the amount that would be determined at that date using a valuation technique (see note below), an entity shall disclose, by class of financial instrument:

(a) its accounting policy for recognising that difference in profit or loss to reflect a change in factors (including time) that market participants would consider in setting a price; and
(b) the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

Note: If the market for a financial instrument is not active, an entity establishes its FV using a valuation technique. Nevertheless, the best evidence of FV at initial recognition is the transaction price, unless the FV of the instrument concerned is evidenced by comparison with other observable current market transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets. It follows that there could be a difference between the FV at initial recognition and the amount that would be determined that date using the valuation technique.

Disclosures of FV are not required:

(a) when the carrying amount is a reasonable approximation of FV, for example, for financial instruments such as short-term trade receivables and payables;

(b) for an investment in equity instruments that do not have a quoted market price in an active market, or derivatives linked to such equity instruments, that is measured at cost because its FV cannot be measured reliably; or

(c) for a contract containing a discretionary participation feature (as described in IFRS 4, Insurance Contracts) if the FV of that feature cannot be measured reliably.

Note: The following FIVE disclosures only require a response if the entity holds either: i. an investment in equity instruments that do not have a quoted market price in an active market, or derivatives linked to such equity instruments, that is measured at cost because its FV cannot be measured reliably; or ii. a contract containing a discretionary participation feature and the FV of that feature cannot be measured reliably.

In the cases described in paras 29 (b) and (c) of IFRS 7 (see above), an entity shall disclose information to help users of the financial
statements make their own judgements about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value including:

7.30
(a) the fact that FV information has not been disclosed for these instruments because their FV cannot be measured reliably;

7.30
(b) a description of the FIs, their carrying amount, and an explanation of why FV cannot be measured reliably;

7.30
(c) information about the market for the instruments;

7.30
(d) information about whether and how the entity intends to dispose of the FIs; and

7.30
(e) if FIs whose FV previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.

NATURE AND EXTENT OF RISKS ARISING FROM FINANCIAL INSTRUMENTS

An entity shall disclose information that enables users of its FS to evaluate the extent and nature of risks arising from FIs to which the entity is exposed at the reporting date.

Notes:
1. The disclosures required by paras 33 to 42 of IFRS 7 (see below) focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, credit risk, liquidity risk and market risk

7.32
2. The disclosures required by paras 31 to 42 shall be either given in the FS or incorporated by cross-reference from the FS to some other statements, such as the management commentary or risk report, that is available to users of the FS on the same terms as the FS and at the same time. Without the information incorporated by cross-reference, the FS are incomplete.
**Qualitative disclosures**

For each type of risk arising from FIs, an entity shall disclose:

7.33

(a) the exposures to risk and

- how the risks arise

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) any changes in 33 (a) or (b) from the previous period.

**Quantitative disclosures**

For each type of risk arising from FIs, an entity shall disclose:

(a) summary quantitative data about its exposure to that risk as at the reporting date. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in IAS 24 Related Party Disclosures), for example the entity's board of directors or chief executive officer.

(b) the disclosures required by paras 36 to 42 (below), to the extent not provided in para 34 (a) (above) unless the risk is not material.
7.34 (c) concentrations of risk if not apparent from 34 (a) and (b) (above) including:

1. a description of how management determines concentrations;

2. a description of the shared characteristic that identifies each concentration (e.g. counterparty, geographical area, currency or market); and

3. the amount of the risk exposure associated with all FIs sharing that characteristic.

Note: Concentrations of risk arise from FIs that have similar characteristics and are affected by changes in economic or other conditions. The identification of concentrations of risk requires judgement taking into account the circumstances of the entity.

If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

**Credit risk**

An entity shall disclose by class of FI:

(a) the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (e.g. netting agreements that do not qualify for offset in accordance with IAS 32)

Notes:

1. for a financial asset the entity's maximum exposure to credit risk is typically the gross carrying amount net of any amounts offset in accordance with IAS 32 and any impairment losses.
2. activities that give rise to credit risk include granting loans, receivable, financial guarantees, making irrevocable loan commitments and entering into derivative contracts. Further guidance is included in IFRS 7.B10.

7.36

(b) in respect of the amount disclosed in 36(a)
a description of collateral held as security and other credit enhancements;

R-S

(c) information about the credit quality of financial assets that are neither past due nor impaired; and

R-S

(d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

R-H

Financial assets that are either past due or impaired

Note: The following THREE disclosures are only required if the entity holds financial assets classified as either past due or impaired.

An entity shall disclose by class of financial asset:

7.37

(a) an analysis of the age of financial assets that are past due as at the reporting date but not impaired;

R-S

(b) an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired; and

R-S

(c) for the amounts disclosed in 37(a) and (b) (above), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of the FV.

R-S

Collateral and other credit enhancements obtained

When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (e.g.
guarantees), and such assets meet the recognition criteria in other Standards, an entity shall disclose:

7.38 (a) the nature and carrying amount of the assets obtained; and

(b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

**Liquidity risk**

An entity shall disclose a maturity analysis for financial liabilities that shows the remaining contractual maturities.

7.39 (a) an entity must use its judgement to determine an appropriate number of time bands;

12. when a counterparty has a choice of when an amount is paid, the liabilities is included on the basis of the earliest date on which the entity can be required to pay;

13. when an entity is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which the entity can be required to pay;

14. the amounts disclosed in the maturity analysis are the contractual undiscounted cash flows. Such undiscounted cash flows differ from the amount included in the balance sheet because the balance sheet amount is based on the discounted cash flows;

15. if appropriate, an entity shall disclose the analysis of derivative FIs separately from that of non-derivatives in the contractual maturity analysis for financial liabilities; and

16. when the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the reporting date.
Further guidance is included in IFRS 7.B11 to B16.

7.39 (b) An entity shall disclose a description of how it manages liquidity risk inherent in 39 (a) above.

**Market risk**

**Sensitivity analysis**

*Note: an entity that prepares a sensitivity analysis, such as value-at-risk, and uses it to manage financial risks may opt to comply with the requirements under 7.41 to disclose the sensitivity to market risk. Otherwise an entity should meet 7.40.*

Unless an entity complies with para 41 of IFRS 7 (below) it shall disclose:

(a) a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;

7.40 (a) R-S

**Notes:**

1. an entity decides how it aggregates info to display the overall picture without combining info with different characteristics about exposures to risks from significantly different economic environments. If an entity has exposure to only one type of market risk in only one economic environment, it would not show disaggregated information;

2. an entity discloses the effect on profit or loss and equity at the balance sheet date assuming that a reasonable possible change in the relevant risk variable had occurred at the balance sheet date and have been applied to the risk exposures in existence at that date;

3. an entity is not required to disclose the effect on profit or loss or equity for each change within a range of reasonable possible changes of the relevant risk variable. Disclosure of the effects of the changes at the limits of the reasonably possible range would be sufficient; and
4. An entity shall provide sensitivity analyses for the whole of its business, but may provide different types of sensitivity analysis for different classes of financial instruments.

Further guidance is available in IFRS 7.B17 to B28.

7.40
(b) the methods and assumptions used in preparing the sensitivity analysis; and

c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g. interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in para 40 of IFRS 7 (above).

Notes:

1. This applies even if such a methodology measures only the potential for loss and does not measure the potential for gain.

2. An entity may also disclose the historical observations period and weightings applied to observations within that period, an explanation of how options are dealt with in the calculations and which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

The entity shall also disclose:

(a) an explanation of the method in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and

(b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the FV of the assets and liabilities involved.

Other market risk disclosures
When the sensitivity analyses disclosed in accordance with para 40 and 41 of IFRS 7 (above) are unrepresentative of a risk inherent (for example because the y/e exposure does not reflect the exposure during the year), the entity shall disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

ADOPTION OF STANDARD BEFORE EFFECTIVE DATE

If an entity applies IFRS 7 for a period beginning before 1 January 2007, it shall disclose that fact.

EXEMPTION IN THE FIRST PERIOD OF ADOPTION BEFORE 1 JANUARY 2006 FROM PRESENTING CERTAIN COMPARATIVE INFORMATION

If an entity applies IFRS 7 for annual periods beginning before 1 Jan 2006, it need not present comparative info for the disclosures required by paras 31 to 42 of the Standard about the nature and extent of risks arising from FIs (above)
Appendix E: Interview details and instruments

Interviewee details

<table>
<thead>
<tr>
<th>Int’ee</th>
<th>Position / role</th>
<th>Industry</th>
<th>Date</th>
<th>Location?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Analyst</td>
<td>Engineering</td>
<td>07/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>2</td>
<td>Investor relations</td>
<td>Utility</td>
<td>08/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>3</td>
<td>Analyst</td>
<td>Transport</td>
<td>07/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>4</td>
<td>Analyst</td>
<td>Telecoms</td>
<td>09/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>5</td>
<td>Regulator</td>
<td>N/A</td>
<td>08/2009</td>
<td>Telephone</td>
</tr>
<tr>
<td>6</td>
<td>Standard setter</td>
<td>IASB</td>
<td>07/2009</td>
<td>Telephone</td>
</tr>
<tr>
<td>7</td>
<td>Treasury Director</td>
<td>Energy</td>
<td>08/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>8</td>
<td>Analyst</td>
<td>Utility</td>
<td>08/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>9</td>
<td>Treasury Director</td>
<td>Technology (defence)</td>
<td>08/2009</td>
<td>Telephone</td>
</tr>
<tr>
<td>10</td>
<td>Finance Director</td>
<td>Property</td>
<td>09/2009</td>
<td>Telephone</td>
</tr>
<tr>
<td>11</td>
<td>Group Financial Controller</td>
<td>Pharmaceuticals</td>
<td>08/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>12</td>
<td>Treasury Director</td>
<td>Retail</td>
<td>02/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>13</td>
<td>Finance Director</td>
<td>Engineering</td>
<td>02/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>14</td>
<td>Analyst</td>
<td>Retail</td>
<td>08/2009</td>
<td>Telephone</td>
</tr>
<tr>
<td>15</td>
<td>Finance Director &amp; Treasury Director</td>
<td>Engineering</td>
<td>02/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>16</td>
<td>Finance Director</td>
<td>Technology</td>
<td>08/2009</td>
<td>Telephone</td>
</tr>
<tr>
<td>17</td>
<td>Analyst</td>
<td>Utility</td>
<td>09/2009</td>
<td>On-site</td>
</tr>
<tr>
<td>18</td>
<td>Analyst</td>
<td>Utility</td>
<td>08/2009</td>
<td>Telephone</td>
</tr>
<tr>
<td>19</td>
<td>Analyst</td>
<td>Retail</td>
<td>09/2009</td>
<td>Telephone</td>
</tr>
<tr>
<td>20</td>
<td>Investor relations</td>
<td>Leisure</td>
<td>07/2009</td>
<td>Telephone</td>
</tr>
</tbody>
</table>

201 Anonymity of the individuals and confidentiality of their responses means that only basic information is provided.
Interview instrument – for internal personnel e.g. finance directors/treasury directors

Background information (establish the following)
1. Name
2. Organisation name / type
3. Industry
4. Ownership
5. Number & nature of sites
6. Experience (nature and length of service) (prior and in current role)

Derivatives usage: background
7. Historic and current derivatives usage? Type, volume, values?
8. What risks are being hedged? E.g. foreign exchange; interest rates; commodity prices; equity related; other?
9. What percentage of these derivatives were principally acquired with a view to hedge account per IAS 39? If not all, why not? Were there any problems meeting the hedge accounting criteria?

Derivative financial instruments based risk management strategies
10. Are derivatives always used for risk management purposes or are other methods employed e.g. netting, natural hedging etc.
11. Where financial instruments are used for risk management purposes, why has this strategy been chosen?\(^\text{202}\)
12. When you do not use financial instruments for risk management purposes, why has this strategy been chosen?\(^\text{203}\)

\(^\text{202}\) Where necessary provide and explain possible rationales. From the literature, these include the following: a. Volatility of earnings?; b. Volatility of cash flows?; c. Volatility of balance sheet?; d. Stabilise earnings?; e. manage investor perceptions of transactions?; f. Speculation?; g. Potential tax savings?; h. Lender perceptions?; i. Internal risk aversion strategy?; j. Facilitate relationships with derivatives brokers?; k. Easier access to borrowing (manage earnings/cash flows)?; l. Manage potential conflicts between shareholders and debt holders?

\(^\text{203}\) As with question 11, if necessary provide and explain possible rationales. From the literature, these might include the following: a. Other ways?; b. Exposures not significant?; c. Disclosure concerns; d. Cost of initiating a programme restrictive; e. Systems constraints?; f. Internal knowledge; g. Shareholders perceptions; h. Lenders perceptions; i. Management perceptions; j. Costs versus benefits of past trades; k. Difficulty pricing/valuing?; l. Industry regulations; m. Tax / legal implications; n. Transaction costs?; o. Increased credit risk?
13. Would you use (derivative) financial instruments more if accounting regulations did not exist?

Disclosure
14. Does the disclosure of financial instruments reflect the economic reality of performance and positions? If not, why? And, (how) could this be improved?
15. Has the accounting regulation led to an increase in quality of information?
16. Has the QUALITATIVE accounting regulation driven information led to an improvement to, or greater fulfilment of, the qualitative characteristics\(^{204}\)?
17. Has the QUANTITATIVE accounting regulation driven information led to an improvement to, or greater fulfilment of, the qualitative characteristics\(^{205}\)?
18. Do the costs of producing the information outweigh the benefits derived?
19. Do you think disclosing hedging makes a difference?
   a. To investors
   b. To lenders
   c. To Board of Directors… secondly, does the BoD encourage or discourage the use of derivatives?
20. Do you think the disclosure adequately summarises the risks of your derivatives position?
21. Do you think phraseology is important to external investors?
22. Who writes this disclosure? And who reviews it?
23. Do you think being audited by one of the elite audit firms makes a difference to the level of disclosure?
24. Have you ever voluntarily disclosed more information than these accounting standards have asked for?
25. Have you ever voluntarily disclosed more information than any accounting standards have asked for?
26. Are there any extra financial instruments related disclosures that you would like to see the IASB mandate?
27. What disclosure requirements would you recommend the IASB removes from the standard?

\(^{204}\) Attempt to get responses in relation to all characteristics if possible. Definitions provided on survey but repeat here if requested.
\(^{205}\) Attempt to get responses in relation to all characteristics if possible. Definitions provided on survey but repeat here if requested.
Interview instrument – for externals e.g. analysts

Background information (establish the following)
1. Name
2. Organisation name / type
3. Specialism
4. Experience (nature and length of service) (prior and in current role)

Disclosure
5. Do you have any concerns about any negative influence of accounting standards on risk management behaviour?
6. Does the disclosure of financial instruments reflect the economic reality of performance and positions? If not, why? And, (how) could this be improved?
7. Has the accounting regulation led to an increase in quality of information?
8. Has the QUALITATIVE accounting regulation driven information led to an improvement to, or greater fulfilment of, the qualitative characteristics?\(^{206}\)
9. Has the QUANTITATIVE accounting regulation driven information led to an improvement to, or greater fulfilment of, the qualitative characteristics?\(^{207}\)
10. Do the costs of producing the information outweigh the benefits derived?
11. Do you think disclosing hedging makes a difference?
   a. To investors
   b. To lenders
   c. To Board of Directors… secondly, does the BoD encourage or discourage the use of derivatives?
12. Do you think the disclosure adequately summarises the risks of the derivatives position?
13. Do you think phraseology is important?
14. Do you think that an entity audited by an elite audit firm will produce higher levels of disclosure?
15. Have you ever noted any evidence of voluntary disclosure i.e. more information than the accounting standards have asked for?

\(^{206}\) Attempt to get responses in relation to all characteristics if possible. Definitions provided on survey but repeat here if requested.

\(^{207}\) Attempt to get responses in relation to all characteristics if possible. Definitions provided on survey but repeat here if requested.
16. Have you ever noticed information being retracted year on year?
17. Are there any extra financial instruments related disclosures that you would like to see the IASB mandate?
18. What disclosure requirements would you recommend the IASB removes from the standard?
Appendix F Analysis of derivatives positions and performance for those firms who omit a reference to non-speculative behaviour

<table>
<thead>
<tr>
<th></th>
<th>Maximum</th>
<th>Minimum</th>
<th>Average</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivative assets (CY)</td>
<td>20,005</td>
<td>1,425</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Derivative assets (PY)</td>
<td>20,264</td>
<td>507</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Derivative liabilities (CY)</td>
<td>20,637</td>
<td>1,543</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Derivative liabilities (PY)</td>
<td>20,381</td>
<td>1,310</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>C/flow hedge G/(L) (CY)</td>
<td>446</td>
<td>446</td>
<td>(116)</td>
<td>(64)</td>
</tr>
<tr>
<td>C/flow hedge G/(L) (PY)</td>
<td>413</td>
<td>3</td>
<td>(201)</td>
<td>(201)</td>
</tr>
<tr>
<td>FV hedge G/(L) (CY)</td>
<td>7</td>
<td>0</td>
<td>(201)</td>
<td>(19)</td>
</tr>
<tr>
<td>FV hedge G/(L) (PY)</td>
<td>40</td>
<td>40</td>
<td>(0)</td>
<td>(0)</td>
</tr>
<tr>
<td>Other derivative G/(L)(CY)</td>
<td>3,254</td>
<td>41</td>
<td>(14)</td>
<td>(14)</td>
</tr>
<tr>
<td>Other derivative G/(L)(PY)</td>
<td>9,694</td>
<td>164</td>
<td>(608)</td>
<td>(11)</td>
</tr>
</tbody>
</table>

Notes:
1. CY = current year; PY = prior year
2. 3 entities are excluded from the second column. The size of their derivatives positions and gains and losses significantly skew the reported statistics and provide an unrepresentative picture.
Appendix G: Robustness checks

Robustness checks were run to ensure that the problems associated with varying measures and definitions of quantity could be considered. Prior literature has argued that sentences are the most appropriate measure of quantity. However, though this is potentially true when looking at purely narrative blocks of text, when looking at mixed quantitative and qualitative disclosures, where a sentence might simply open the door to large blocks of quantitative disclosures, this seems an inappropriate measure and therefore this data has not been collected.

Instead however, one might argue that the number of pages devoted to financial instruments disclosures is an appropriate measure. One must be extremely careful however in the way this is measured. Annual reports are made up of different fonts, different font sizes, and different page sizes dependent upon internal and external presentational requirements and choices. Also, the number of pages might be influenced, either consciously or subconsciously, by the amount of attention the report writers want to attach to the disclosures. Therefore, it is important to be careful about interpreting the data collected.

When defining the number of pages as a measure of quantity, the following has been collected and tested:

- The number of pages of financial instruments disclosures in the annual report as a percentage of the number of pages of the annual report as a whole (%age).
- The number of pages of financial instruments disclosures in the annual report as a percentage of the number of pages of the annual report as a whole when converted into Microsoft Word and set in Arial font, size 8 (%age).

The number of lines was also used to check the robustness of the quantity regression results. The following measure was taken:

- The percentage of lines of financial instruments disclosures as a percentage of the number of lines in the annual report as a whole (%age).
In addition to these robustness tests, the actual measure of quantity (word count) was also substituted for the relative measure.

The descriptive statistics are shown in Table A and the regression results appear in Table B. The results clearly show that the findings as presented in Section 5.3 are robust. There is only one minor difference worth noting. This is the relationship between the number of pages of financial instruments disclosures as a proportion of the annual report and the size of the firm measured as the log of total assets. Though consistently insignificant throughout the results, it is important to note that the directional result changes when compared to the number of words. The results indicate a statistically insignificant positive association between the quantity of disclosure and the size of the entity. The easiest way to justify this discrepancy between results is that more pages are devoted to quantitative disclosures the larger a firm gets, purely as they tend to hold more financial instruments and thus the tables of information are longer and larger. Though these quantitative disclosures might be informative, this is often not the type of quantity that acts as a direct proxy for quality. In addition, there is nothing to differentiate the quality of a smaller company’s tables from a larger company’s.
### Table A: Descriptive statistics

<table>
<thead>
<tr>
<th></th>
<th>Total # of pages in the annual report</th>
<th>Total # of pages of FIs disclosures</th>
<th>%age of FIs pages</th>
<th>Total # of pages of FIs disclosures</th>
<th>%age of FIs pages</th>
<th># of words of FIs, der. s and fin. risk (IFRS 7)</th>
<th>Total lines in the annual report</th>
<th>Lines of FIs disclosures</th>
<th>%age of lines of FIs disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>MAX</td>
<td>286.00</td>
<td>12.50</td>
<td>10.1%</td>
<td>15.00</td>
<td>10.5%</td>
<td>7,542</td>
<td>9,312.00</td>
<td>981.00</td>
<td>21.1%</td>
</tr>
<tr>
<td>MIN</td>
<td>64.00</td>
<td>1.50</td>
<td>0.8%</td>
<td>2.00</td>
<td>1.5%</td>
<td>1,228</td>
<td>1,278.00</td>
<td>117.00</td>
<td>2.0%</td>
</tr>
<tr>
<td>MEAN</td>
<td>142.06</td>
<td>5.44</td>
<td>4.0%</td>
<td>5.84</td>
<td>4.3%</td>
<td>2,972</td>
<td>4,683.56</td>
<td>372.35</td>
<td>8.9%</td>
</tr>
<tr>
<td>ST’D DEV’N</td>
<td>41.73</td>
<td>2.61</td>
<td>2.0%</td>
<td>2.51</td>
<td>1.9%</td>
<td>1,329</td>
<td>1,822.19</td>
<td>180.76</td>
<td>4.7%</td>
</tr>
</tbody>
</table>

### Table B: Multiple regression results

<table>
<thead>
<tr>
<th></th>
<th>%age AR pages</th>
<th>%age of pages (Arial)</th>
<th>%age lines</th>
<th>Actual no. of words</th>
<th>Words (as shown in findings section above)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Coefficient</td>
<td>t-stat</td>
<td>Coefficient</td>
<td>t-stat</td>
<td>Coefficient</td>
</tr>
<tr>
<td>QUAL</td>
<td>0.0678</td>
<td>1.5195</td>
<td>0.0392</td>
<td>0.8854</td>
<td>0.1651</td>
</tr>
<tr>
<td>MKT</td>
<td>-0.0027</td>
<td>-1.1843</td>
<td>-0.0026</td>
<td>-1.1881</td>
<td>-0.0057</td>
</tr>
<tr>
<td>MANOWN</td>
<td>-0.0113</td>
<td>-0.5339</td>
<td>-0.0186</td>
<td>-0.8875</td>
<td>-0.0715</td>
</tr>
<tr>
<td>NEWSANALYST</td>
<td>-0.0022</td>
<td>-3.3230</td>
<td>-0.0014</td>
<td>-2.1172</td>
<td>-0.0034</td>
</tr>
<tr>
<td>SHISUE</td>
<td>-0.0076</td>
<td>-1.2686</td>
<td>-0.0090</td>
<td>-1.5220</td>
<td>-0.0099</td>
</tr>
<tr>
<td>SIZE</td>
<td>0.0006</td>
<td>0.2132</td>
<td>0.0035</td>
<td>1.2071</td>
<td>0.0101</td>
</tr>
<tr>
<td>LEV</td>
<td>-0.0000</td>
<td>-0.0006</td>
<td>0.0003</td>
<td>0.3199</td>
<td>0.0002</td>
</tr>
<tr>
<td>PROF</td>
<td>0.0312</td>
<td>1.5228</td>
<td>0.0393</td>
<td>1.9305</td>
<td>0.0940</td>
</tr>
<tr>
<td>VOL</td>
<td>0.0011</td>
<td>0.1455</td>
<td>0.0035</td>
<td>0.4584</td>
<td>0.0048</td>
</tr>
<tr>
<td>DERASS</td>
<td>-0.0001</td>
<td>-0.0796</td>
<td>0.0017</td>
<td>1.3628</td>
<td>0.0019</td>
</tr>
</tbody>
</table>

---

208 All converted to standard font (Arial) and font sizes (9).
209 As footnote above.
Appendix H: The survey instrument

Please indicate your level of agreement to the series of statements below based on a five-point scale, with 5 being strongly agree; 4 being somewhat agree; 3 being neither agree nor disagree; 2 being somewhat disagree; and 1 being strongly disagree.

I would be grateful for any supplementary comments related to any of the questions below. If there is not enough space provided then please continue onto a separate sheet.

1. Qualitative disclosure

IFRS 7 requires that a firm narrates the risks associated with the use of financial instruments and the associated objectives, policies, procedures and methods related to their usage.

Please show your level of agreement indicating whether you feel this qualitative disclosure aids the fulfilment of the following fundamental characteristics of the financial statements:

- [ ] Relevance
- [ ] Reliability / fair representation
- [ ] Comparability
- [ ] Understandability
- [ ] Verifiability
- [ ] Timeliness

Please note that normally we assume that accounting information strives to be:
- Relevant: able to influence decisions;
- Reliable (fair representation): free from significant error and bias;
- Comparable: enable users to identify changes in the business over time or compare the performance of the business with others;
- Understandable: capable of being understood by those at whom the information is aimed;
- Verifiable: information that aims to faithfully represent the economic phenomena that it purports to represent; and
- Timely: to make information available to decision makers before it loses its capacity to influence decisions.

2. Quantitative disclosure

IFRS 7 requires that a firm summarises their quantitative position in relation to their financial instruments. The key issues outlined by IFRS 7 include the disclosure of:

- the carrying value of the financial instruments (carrying value);
- the fair value of the financial instruments (fair value);
- the value of any hedged positions, including hedged items and hedging instruments (hedging);
- sensitivity analysis (sensitivity); and
- other quantitative disclosure including the level of collateral pledged or held & the details of any defaults and breaches (other).

Please show your level of agreement indicating whether you feel this quantitative disclosure aids the fulfilment of the following fundamental characteristics of the financial statements:

<table>
<thead>
<tr>
<th>Carrying Value</th>
<th>Fair Value</th>
<th>Hedging</th>
<th>Sensitivity</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Relevance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b) Reliability / fair representation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c) Comparability</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d) Understandability</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e) Verifiability</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f) Timeliness</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Only the results from Questions 1 and 2 appear in this study.
Please indicate your level of agreement to the series of statements below based on a five-point scale with 5 being strongly agree; 4 being somewhat agree; 3 being neither agree nor disagree; 2 being somewhat disagree; and 1 being strongly disagree. Each box contains space for any brief additional comments; however please feel free to continue onto a separate sheet.

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>3.</td>
<td>IFRS 7 requires firms to produce <strong>qualitative</strong> information where it is immaterial to do so</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>IFRS 7 requires firms to produce <strong>quantitative</strong> information where it is immaterial to do so</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Firms benefit <strong>operationally</strong> from the production of the information outlined by IFRS 7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Firms benefit <strong>strategically</strong> from the production of the information outlined by IFRS 7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.</td>
<td>Firms disclosure of financial instruments is primarily <strong>substantive</strong> in nature i.e. attempts to portray behaviour and events translucently</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td>Firms disclosure of financial instruments is primarily <strong>symbolic</strong> in nature i.e. attempts to deflect attention</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9.</td>
<td>Institutional investors benefit from the production of the information outlined by IFRS 7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10.</td>
<td>Information disclosed in line with IFRS 7 aids the decision-making capabilities of other users i.e. aside from institutional investors (e.g. government, customers, suppliers, employees and so forth)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11.</td>
<td>The Big Four audit firms have the knowledge, technical expertise and resources to review and/or produce the disclosure required by IFRS 7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12.</td>
<td>Mid-tier audit firms (i.e. firms with 20 partners or more excluding the Big Four) have the knowledge, technical expertise and resources to review and/or produce the disclosure required by IFRS 7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13.</td>
<td>Audit firms outside of the Big Four and mid-tier firms have the knowledge, technical expertise and resources to review and/or produce the disclosure required by IFRS 7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14.</td>
<td>The benefits of producing the disclosure required by IFRS 7 outweigh the costs of its production</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15.</td>
<td>Financial instrument based risk management strategies are <strong>unaffected</strong> by the disclosure required by the financial instruments standards</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16.</td>
<td>More disclosure is required related to financial instruments, <strong>excluding derivative financial instruments</strong>, in the annual report and financial statements</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17.</td>
<td>More disclosure is required related to <strong>derivative financial instruments</strong> in the annual report and financial statements</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18.</td>
<td>The mandated disclosure of IFRS 7 would have been produced on a voluntary basis if this standard had not been written</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Appendix I: Analysis of comments requested and amended by respondent

There are two summaries that follow. The first summary is a series of graphs which summarises respondents into broad categories. The graphs show the distribution of accepted proposed changes by respondent group and the percentage breakdown. The second is a more detailed summary that shows the nature of these comments by paragraph and by individual respondent.

Respondents proposed amendments processed through to IFRS 7 from ED 7 analysed by paragraph

Key:
PROF/ACC’G = Professional accounting organisation/body
PROF/BANK = Professional banking organisation/body
PROF/INS = Professional insurance organisation/body
PROF/OTHER = Other industry/sector professional organisation/body
P/FI = Preparers – financial institutions (excluding insurance)
P/INS = Preparers – insurance
P/O = Preparers – other
O = Other
AUD = Audit firms

Paragraph 3 amendments

![Graph showing number of amendments proposed and accepted by different groups.](image-url)
Paragraph 6 amendments

![Bar chart showing the number of amendments proposed and accepted for PROF / ACC’G, PROF / BANK, AUD, and O.]

Paragraph 8 amendments

![Bar chart showing the number of amendments proposed and accepted for PROF / ACC’G, PROF / BANK, PROF / OTHER, and AUD.]

No. of amend'ts proposed and accepted
%age of amend'ts
Paragraph 10 amendments

![Paragraph 10 amendments chart]

- No. of amend'ts proposed and accepted
- %age of amend'ts

Paragraph 11 amendments

![Paragraph 11 amendments chart]

- No. of amend'ts proposed and accepted
- %age of amend'ts
Paragraph 12 amendments

<table>
<thead>
<tr>
<th>No. of amend'ts proposed and accepted</th>
<th>%age of amend'ts</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROF / ACC’G</td>
<td>0</td>
</tr>
<tr>
<td>PROF / BANK</td>
<td>0.5</td>
</tr>
<tr>
<td>PROF / INS</td>
<td>1</td>
</tr>
<tr>
<td>P / O</td>
<td>1.5</td>
</tr>
<tr>
<td>AUD</td>
<td>2</td>
</tr>
</tbody>
</table>

Paragraph 15 amendments

<table>
<thead>
<tr>
<th>No. of amend'ts proposed and accepted</th>
<th>%age of amend'ts</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROF / BANK</td>
<td>2</td>
</tr>
<tr>
<td>P / FI</td>
<td>1</td>
</tr>
<tr>
<td>AUD</td>
<td>1.5</td>
</tr>
</tbody>
</table>
Paragraph 17 amendments

![Bar chart showing the number of amendments proposed and accepted for different roles: PROF / ACC’G, PROF / BANK, and AUD.]

Paragraph 21 amendments

![Bar chart showing the number of amendments proposed and accepted for different roles: PROF / ACC’G, PROF / BANK, PROF / OTHER, P / FI, and AUD.]

Paragraph 27 amendments

![Chart showing number of amendments proposed and accepted for different groups.]

Paragraph 29 amendments

![Chart showing number of amendments proposed and accepted for PROF / ACC'G.]

Paragraph 35 amendments

![Bar chart for Paragraph 35 amendments]

Paragraph 39 amendments

![Bar chart for Paragraph 39 amendments]
Paragraph 40 amendments

![Bar chart showing the number of amendments proposed and accepted for different roles.]

Paragraph 42 amendments

![Bar chart showing the number of amendments proposed and accepted for different roles.]

- No. of amend'ts proposed and accepted
- %age of amend'ts
Paragraph 43 amendments

Paragraph 44 amendments
Paragraph 46 amendments

No. of amend'ts proposed and accepted
%age of amend'ts

Paragraph 47 amendments

No. of amend'ts proposed and accepted
%age of amend'ts
Paragraph 48 amendments

No. of amend'ts proposed and accepted

%age of amend'ts

Paragraph 49 amendments

No. of amend'ts proposed and accepted

%age of amend'ts
General comments amendments

![Bar chart showing the number of amendments proposed and accepted for different categories: PROF / BANK, PROF / OTHER, AUD. The chart includes bars for the number of amendments proposed and accepted and a percentage of amendments.](image)
### Detailed summary of accepted proposed amendments by paragraph by respondent.

<table>
<thead>
<tr>
<th>ED 7 paragraph number</th>
<th>Topic</th>
<th>Request</th>
<th>Changes made</th>
<th>By whom</th>
</tr>
</thead>
<tbody>
<tr>
<td>Para 1</td>
<td>Objective</td>
<td>1b: Nature and extent</td>
<td>grammatical change (rephrasing)</td>
<td>None</td>
</tr>
<tr>
<td>Para 2</td>
<td>Objective</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Para 3</td>
<td>Scope (Exemptions)</td>
<td>3a Consolidation:</td>
<td>grammatical change (rephrasing)</td>
<td>CL11 Florida Institute of Certified Public Accountants (USA) CL47 International Swaps and Derivatives Association CL60 Royal Bank of Scotland Group plc</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3c Contracts for contingent consideration exemption:</td>
<td>deleted</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>3d Insurance contracts</td>
<td>Choice between IFRS 4 para 4d or IFRS 7 re financial guarantee contracts</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3f FIs classified as equity per para 16a and 16b or para 16c and 16d per IAS 32</td>
<td>Added this further exemption</td>
<td>None</td>
</tr>
<tr>
<td>Para 4</td>
<td>Scope</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Para 5</td>
<td>Scope</td>
<td>Contracts to buy / sell</td>
<td>Grammatical change</td>
<td>None</td>
</tr>
<tr>
<td>Para 6</td>
<td>Scope (Capital)</td>
<td>Capital disclosures</td>
<td>Deleted (see also paras 48 and 49)</td>
<td>CL21 Deloitte Touche Tohmatsu International CL18 London Investment Banking Association (LIBA) (UK) CL32 South African Institute of Chartered Accountants (SAICA) CL38 Institute of Chartered Accountants</td>
</tr>
<tr>
<td>Para 7</td>
<td>Classes of FIs and level of disclosure</td>
<td>Classes of instrument</td>
<td>Delete phrase which could be misleading highlighting how classes could be determined. Delete phrase about presentation of FIs not within the scope of IFRS 7.</td>
<td>None</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Para 8</td>
<td>Classes of FIs and level of disclosure (level determined by entity)</td>
<td>Deleted</td>
<td>Clause reworded to read: &quot;An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.&quot;</td>
<td>CL09 Australian Accounting Standards Board (AASB) CL19 Bundesverband Öffentlicher Banken Deutschlands CL21 Deloitte Touche Tohmatsu International CL43 Industrie-Holding CL47 International Swaps and Derivatives Association (ISDA) CL69 International Organization of Securities Commissions (IOSCO) CL79 Council on Corporate Disclosure and Governance</td>
</tr>
<tr>
<td>Para 9</td>
<td>Significance of FIs for Fin position and perf.</td>
<td>None</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Para 10</td>
<td>Significance of FIs for Fin position and perf. (Min disc.s Balance Sheet) [Classification]</td>
<td>10 - Location</td>
<td>Amended to say: “shall be disclosed on the face of the balance sheet or in the notes”</td>
<td>CL99 European Association of Cooperative Banks CL13 Föreningen Auktoriserade Revisorer FAR CL14 Institute of Chartered Accountants in Ireland (ICAI) CL32 South African Institute of Chartered Accountants (SAICA) CL43 Industrie-Holding CL68 Nicki L. Tillinghast CL83 Group of North American Insurance Enterprises</td>
</tr>
</tbody>
</table>
| Para | Significance of FLs for Fin position and perf. | Wording change: “financial liability” deleted and replaced with “loan or receivable (or group of loads or receivables)” | CL14 Institute of Chartered Accountants in Ireland (ICAI)  
CL18 London Investment Banking Association (LIBA)  
CL21 Deloitte Touche Tohmatsu International  
CL32 South African Institute of Chartered Accountants (SAICA)  
CL47 International Swaps and Derivatives Association (ISDA) |
|---|---|---|---|
| Para 11 | Intro - definition | “Benchmark interest rate changed to “market conditions that give rise to market risk”  
PLUS: note added which defines market risk. | CL10 German Accounting Standards Committee (DRSC)  
CL30 German Co-operative and Raiffeisen Confederation  
CL30 German Co-operative and Raiffeisen Confederation (not repetition)  
CL32 South African Institute of Chartered Accountants (SAICA)  
CL64 Institut der Wirtschaftsprüfer (IDW)  
CL82 European Banking Federation  
CL99 European Association of Co-operative Banks |
| Para 12 | 12a – d: All deleted | 12a – deleted para related to IRR  
12b – deleted para re PV of liability  
12c – deleted para re decreasing PV calculated in b for any cash paid during the period  
12d – deleted para re difference between the observed market price | CL32 South African Institute of Chartered Accountants (SAICA)  
CL38 Institute of Chartered Accountants in England & Wales (ICAEW)  
CL72 AstraZeneca |
| | | 12a – d added | CL18 London Investment Banking Association (LIBA)  
CL38 Institute of Chartered Accountants in England & Wales (ICAEW)  
CL64 Institut der Wirtschaftsprüfer (IDW) |
<p>| | | 12b: Asks for disclosure of: Whether any other | |</p>
<table>
<thead>
<tr>
<th>Para 13</th>
<th>Significance of FSs for Fin position and perf. (Min disc.s Balance Sheet) [Reclassifications]</th>
<th>Reclassification wording change</th>
<th>Logical correction: Wording order change</th>
<th>None</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>CL13 Föreningen Auktoriserade Revisorer FAR CL21 Deloitte Touche Tohmatsu International CL78 Institute of Chartered Accountants of New Zealand CL95 Committee of European Banking Supervisors CL95 Committee of European Banking Supervisors (not repetition)</td>
</tr>
<tr>
<td>Para 14</td>
<td>Significance of FSs for Fin position and perf. (Min disc.s Balance Sheet) [Derecognition]</td>
<td>Derecognition intro</td>
<td>Deleted the proposed secondary way an entity might give rise to a derecognition i.e. deleted: “or entered into the type of arrangement described in para 19 of IAS 39” and deleted associated sub-clause.</td>
<td>None</td>
</tr>
<tr>
<td>Para 15</td>
<td>Significance of FIs for Fin position and perf. (Min disc.s Balance Sheet) [pledged collateral]</td>
<td>Wording change to ensure that partial derecognition is also captured</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>---------</td>
<td>-----------------------------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------</td>
<td>------</td>
<td></td>
</tr>
<tr>
<td>14a-d</td>
<td>Grammatical change: Asset and liability pluralised</td>
<td>None</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14d</td>
<td>Grammatical change</td>
<td>None</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15a</td>
<td>15a – definition amendment / enhancement. Also bringing in contingent element from 15b</td>
<td>Used to read: “pledged as collateral for liabilities” Added to the end of this: “...or contingent, including amounts that have been reclassified in the balance sheet separately from other assets as the transferee has the right to sell or repledge the collateral”</td>
<td>CL21 Deloitte Touche Tohmatsu International CL25 Japanese Bankers Association CL51 BNP Paribas</td>
<td></td>
</tr>
<tr>
<td>15b</td>
<td>15b – contingent element</td>
<td>change assets to ‘financial assets’</td>
<td>CL21 Deloitte Touche Tohmatsu International</td>
<td></td>
</tr>
<tr>
<td>Para 16</td>
<td>Significance of FIs for Fin position and perf. (Min disc.s Balance Sheet) [holding collateral]</td>
<td>Intro / definition – changed “has accepted” to “holds”</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Wording changed from: “When an entity has accepted collateral” to “when an entity holds collateral (of financial or non-financial assets) and...” All subsequent refs to accepted changed to ‘holds’.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Clarification of the allowance account definition</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Para 18</td>
<td>Significance of FIs for Fin position and perf. (Min disc.s Balance Sheet) [Embedded derivative]</td>
<td>Correction: Delete reference to IAS 32</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td></td>
</tr>
<tr>
<td>Para 19</td>
<td>Significance of FIs for Fin position and perf. (Min disc.s Balance Sheet) [Defaults and breaches]</td>
<td>Defaults and breaches: Definition amendment to ensure all components captured in 19a-c</td>
<td>Moved definition clause to 19a</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>19a: Move definition 19a: wording change definition clause moved from 19</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>19b: Move definition 19b: grammatical change</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>19c: Broaden information capture (based on para 20) 19c: deleted reference to 19b to ensure captures all defaults Amended and enhanced explanatory note enhancing the requirements to disclose breaches of any loan agreements not captured by 19a-c</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Para 20</td>
<td>Significance of FIs for Fin position and perf. (Min disc.s Balance Sheet) [breaches of loan agreements]</td>
<td>Deleted</td>
<td>Moved to 19c</td>
<td></td>
</tr>
<tr>
<td>Para 21</td>
<td>Income Statement and equity</td>
<td>21 amended</td>
<td>Specifies where the disclosure is required i.e. face of the F/S or the notes. CL18 London Investment Banking Association (LIBA) CL21 Deloitte Touche Tohatsu</td>
<td></td>
</tr>
<tr>
<td>Paragraph Numbers</td>
<td>Changes and Revisions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-------------------</td>
<td>-----------------------</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>[Income, expense, gains and losses]</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21ai</td>
<td>Wording change: from “designated as FV through Profit or loss” to “designated as such on initial recognition and those on FAs or FLs that are classified as held for trading”</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21b – interest and dividend income clause</td>
<td>Deleted and rewritten (for greater clarity)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21d – interest income/expense</td>
<td>Minor grammatical changes including separate recognition (‘and’ for ‘or’)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Para 22 becomes 21e – impairment losses</td>
<td>Wording change to enhance definition</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Para 22</td>
<td>Income Statement and equity [impairment losses] Moved to 21 as 21e</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Para 23</td>
<td>Accounting policies Definition Wording change to ensure disclosure captures information that is “relevant to an</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

International CL32 South African Institute of Chartered Accountants CL90 Federation Bancaire Francaise CL92 Societe Generale CL93 Institute of Certified Public Accountants of Cyprus

CL21 Deloitte Touche Tohmatsu International

CL21 Deloitte Touche Tohmatsu International CL32 South African Institute of Chartered Accountants (SAICA) CL49 Conseil National de la Comptabilité (CNC) CL96 European Savings Bank Groups

CL15 Raad voor de Jaarverslaggeving (Council for Annual Reporting) CL21 Deloitte Touche Tohmatsu International CL47 International Swaps and Derivatives Association (ISDA) CL49 Conseil National de la Comptabilité (CNC) CL50 PricewaterhouseCoopers CL77 J.P. Morgan

None None None
<table>
<thead>
<tr>
<th>Para</th>
<th>Change</th>
<th>Description</th>
<th>Author</th>
</tr>
</thead>
<tbody>
<tr>
<td>23a</td>
<td>wording change</td>
<td>Wording change so as to capture all designated rather than just those designated on initial recognition</td>
<td>None</td>
</tr>
<tr>
<td>23a</td>
<td>additional disclosures</td>
<td>Added three part definition of what is required to be disclosed for FAs and FLs as at FV through profit or loss incl.: i. The nature of the FAs and FLs; ii. The criteria for designating them as such; iii. How the entity has satisfied the condition for designation.</td>
<td>CL62 Foreningen af Statsautoriserede Revisorer (FSR)</td>
</tr>
<tr>
<td>23c</td>
<td>23c – removed reference to IAS 39</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>23d</td>
<td>Minor word order change</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>23e</td>
<td>Bring in issue of dividend income and interest And separate out impairment clause to para 23f</td>
<td>Additional disclosure re. Recognition of net gains and losses including interest or dividend income.</td>
<td>None</td>
</tr>
<tr>
<td>23f</td>
<td>original 23f moved to 23g to make way for impairment requirement</td>
<td>Additional clause about ‘objective evidence’ to be disclosed in relation to impairment losses.</td>
<td>CL21 Deloitte Touche Tohmatsu International CL48 British Bankers’ Association (BBA)</td>
</tr>
<tr>
<td>23g</td>
<td>moved from 23f. Past due clause amended</td>
<td>Additional clarificatory clause about renegotiated terms for financial assets on those that would ordinarily be recorded as past due or impaired.</td>
<td>CL38 Institute of Chartered Accountants in England &amp; Wales CL47 International Swaps and Derivatives Association (ISDA) CL50 PricewaterhouseCoopers</td>
</tr>
<tr>
<td>Para 24</td>
<td>Hedge Accounting [qualitative disclosure]</td>
<td>Changed list of hedge categories to: “for each type of hedge”</td>
<td>CL78 Institute of Chartered Accountants of New Zealand</td>
</tr>
<tr>
<td>24a</td>
<td>clarification</td>
<td>Wording change for clarity</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td>Changed 24d into a new paragraph dealing specifically with cash</td>
<td>Brought in the requirements in para 25 into para 24 largely unchanged with minor grammatical and word order changes. Combined qualitative</td>
<td>CL81 KPMG</td>
</tr>
<tr>
<td>Para 25</td>
<td>Hedge Accounting [quantitative disclosure]</td>
<td>See above</td>
<td>Added paragraphs b) and c) to deal with ineffectiveness disclosure requirements i.e. how much recognised in relation to cash flow hedges and in relation to hedges of net investments in for. ops.</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td><strong>Para 26</strong></td>
<td>Fair value [Carrying amount]</td>
<td>Scope amended</td>
<td>Scope amended given changes to location of disclosure i.e. no longer solely balance sheet. Also a note added stating that when disclosing fair values it is only permitted to offset to the degree the FIs are offset in the B/S (brought forward from para ED7.28).</td>
</tr>
<tr>
<td><strong>Para 27</strong></td>
<td>Fair value [assumptions and valuation technique]</td>
<td>Carrying amount scope amended and definition clarification re classes</td>
<td>Clause added re enhancement of comparability between fair value and carrying value.</td>
</tr>
<tr>
<td>27a section brought forward from ED7.31</td>
<td>Wording changes for clarification purposes but this disclosure was previously required in ED7.31</td>
<td>CL41 Ernst &amp; Young CL60 Royal Bank of Scotland Group plc CL67 Italian Banking Association (ABI) CL95 Committee of European Banking Supervisors</td>
<td></td>
</tr>
<tr>
<td>27b clarification</td>
<td>Words removed/changed to enable clearer interpretation</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>27c – valuation technique clarification</td>
<td>Amended the requirement “that are not supported by observable market prices or rates” to: “that are not supported by prices from observable current market transactions in the</td>
<td>CL38 Institute of Chartered Accountants in England &amp; Wales (ICAEW) CL59 Association of Chartered Certified Accountants (ACCA) CL60 Royal Bank of Scotland Group plc</td>
<td></td>
</tr>
<tr>
<td>Para</td>
<td>Fair value [offset; reconciliation of differences]</td>
<td>Difference between FV at initial recognition and carrying value</td>
<td>Added requirements related to the accounting policy for recognition of changes and factors market participants would consider in setting a price; a reconciliation of changes in the B/S and any difference. Plus, added a note added dealing with how to treat a FI where there is not an active market.</td>
</tr>
<tr>
<td>------</td>
<td>--------------------------------------------------</td>
<td>---------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>28</td>
<td>Off set clause taken to para 26</td>
<td></td>
<td></td>
</tr>
<tr>
<td>29a</td>
<td>Scope</td>
<td>Minor wording change</td>
<td></td>
</tr>
<tr>
<td>29b</td>
<td>29a – requirement added Therefore, 29a moved to 29b and so forth</td>
<td>Added a requirement dealing with FAs and FLs where C.V. is a reasonable approximation of F.V. e.g. trade receivables</td>
<td>CL59 Association of Chartered Certified Accountants</td>
</tr>
<tr>
<td>29c</td>
<td>Minor wording changes: “unquoted” changes to “where no active market”</td>
<td>Minor wording change</td>
<td></td>
</tr>
<tr>
<td></td>
<td>29c – discretionary</td>
<td>Minor wording change</td>
<td></td>
</tr>
<tr>
<td>Para</td>
<td>Fair value</td>
<td>Requirements moved to para 27c and 28</td>
<td>Changed from: “risks arising from FIs to which the entity was exposed during the period” to: “to which the entity is exposed at the reporting date”.</td>
</tr>
<tr>
<td>--------</td>
<td>-----------------------------------------</td>
<td>----------------------------------------</td>
<td>---------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Para 30</td>
<td>“Financial assets” changed to “financial instruments” “Sold” changed to “derecognised”</td>
<td>Para 30e – change of scope</td>
<td>None</td>
</tr>
<tr>
<td>Para 31</td>
<td>[disclosing adequately where estimates used]</td>
<td>Requirements moved to para 27c and 28</td>
<td>See 27a</td>
</tr>
<tr>
<td>Para 32</td>
<td>Nature and extent of risks arising from FIs [methods and assumptions – valuation technique]</td>
<td>Scope of nature and extent changed</td>
<td>None</td>
</tr>
<tr>
<td>Para 33</td>
<td>Nature and extent of risks arising from FIs [types of risk i.e. credit, liquidity and market]</td>
<td>Changed to be a note to para 32 plus added extra note</td>
<td>Extra note added: allows cross referencing but states that without a cross-reference the FS are incomplete.</td>
</tr>
<tr>
<td>Para 34</td>
<td>Nature and extent of risks arising from FIs [Qualitative disclosures]</td>
<td>34a definition</td>
<td>Grammatical change to ensure risks are pluralised</td>
</tr>
<tr>
<td>Para 35</td>
<td>Nature and extent of risks arising from FIs [Quantitative disclosures]</td>
<td>Scope clarification</td>
<td>Wording change: from “each risk” to “each type of risk”</td>
</tr>
<tr>
<td></td>
<td>35a scope change</td>
<td>Change from “data about the extent to which it is exposed” to “data about its exposure”</td>
<td>None</td>
</tr>
<tr>
<td>Para 36</td>
<td>Nature and extent of risks arising from FIs [if quant. discs are unrepresentative]</td>
<td>Consolidation of disclosures related to concentrations of risk and the disclosure required.</td>
<td>Copied in from para 38</td>
</tr>
<tr>
<td>---------</td>
<td>----------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td>Para 37</td>
<td>Nature and extent of risks arising from FIs [Several methodologies]</td>
<td>Moved to be a note attached to para 35</td>
<td>Moved / downgraded to a note to para 35</td>
</tr>
<tr>
<td>Para 38</td>
<td>Nature and extent of risks arising from FIs [Similar characteristics]</td>
<td>Moved to be a note attached to para 36</td>
<td>Moved / downgraded to a note to para 36</td>
</tr>
<tr>
<td>Para 39</td>
<td>Nature and extent of risks arising from FIs [Credit risk]</td>
<td>Scope</td>
<td>Wording change to ensure capture all information</td>
</tr>
<tr>
<td></td>
<td>39a example added</td>
<td>Added an example of another credit</td>
<td>CL32 South African Institute of</td>
</tr>
<tr>
<td>Paragraph</td>
<td>Description</td>
<td>Notes</td>
<td></td>
</tr>
<tr>
<td>-----------</td>
<td>-------------</td>
<td>-------</td>
<td></td>
</tr>
<tr>
<td>39 a</td>
<td>Explanatory notes added</td>
<td>There are then 2 added explanatory notes: 1. Clarification of what is meant by the phrase <em>maximum exposure</em></td>
<td></td>
</tr>
<tr>
<td>39 b</td>
<td>Deleted clause</td>
<td>Asks for a description of collateral pledged but allowed fair value disclosures if impracticable. Final Standard deleted this option and got rid of the phrase “unless impracticable, their fair values”</td>
<td></td>
</tr>
<tr>
<td>39 d</td>
<td>Clarification</td>
<td>Clarificatory sentence to capture information about past due or impaired setting within the construct of renegotiation.</td>
<td></td>
</tr>
<tr>
<td>40 b</td>
<td>Clarification</td>
<td>Added the phrase: “individually determined to be” impaired</td>
<td></td>
</tr>
<tr>
<td>40 c</td>
<td>Wording changes</td>
<td>Wording changes to clarify what is required and to acknowledge that fair values might be estimates.</td>
<td></td>
</tr>
</tbody>
</table>
| Para 41 | Nature and extent of risks arising from FIs [Collateral and other credit enhancements obtained] | 41 several wording changes clarification | 1. Changed “assets” to “financial or non-financial assets”  
2. Changed “taking control” to “taking possession”  
3. Changed “collateral pledged” to “collateral it holds”  
4. Added extra category to “and such assets meet the recognition criteria in other Standards” | None |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>41a moved requirement for quant. disclosure from 41b</td>
<td>41b stated fair value less costs to obtain be disclosed. 41a now asks for the <strong>carrying amount</strong>.</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td></td>
<td>41c Additional disclosure for clarification</td>
<td>Adds the requirement that when assets are not readily convertible into cash and does not plan to use in operations a requirement to say how they might use them in operations.</td>
<td>None</td>
</tr>
</tbody>
</table>
| Para 42 | Nature and extent of risks arising from FIs [Liquidity risk] | Added explanatory notes containing additional disclosures to fulfil the scope of the requirement | 6 additional notes:  
1. Appropriate time banks  
2. Details of counterparty  
3. Details of instalments  
4. Disclosure of contractual undiscounted cash flows (might differ from B/S which holds discounted cash flows)  
5. Analysis of derivatives from non-derivatives in the maturity analysis  
6. Details of any fixed payment conditions | CL95 Committee of European Banking Supervisors  
CL95 Committee of European Banking Supervisors (not repetition)  
CL91 British American Tobacco  
None  
None |
| Para 43 | Nature and extent of risks arising from FIs [Market risk – sensitivity analysis] | Scope of sensitivity analysis | Wording change to ensure that an entity reports each type of market risk to which it is exposed | CL52 Association pour la participation des entreprises françaises à l'harmonisation comptable internationale (ACTEO) and Mouvement des Entreprises de France (MEDEF) |
### 43a Additional guidance notes added

<table>
<thead>
<tr>
<th>Clause</th>
<th>Note</th>
<th>Source</th>
</tr>
</thead>
</table>
| 1. | Clarification that an entity can decide how it aggregates information | CL18 London Investment Banking Association (LIBA)  
CL30 German Co-operative and Raiffeisen Confederation  
CL64 Institut der Wirtschaftsprüfer (IDW)  
CL77 J.P. Morgan Chase |
| 2. | An entity discloses the effect on profit or loss and equity of changes assuming that a *reasonable change in the relevant risk variable had occurred at the B/S date* | None |
| 3. | Not necessary to show the effect for each change within a range of reasonable possible changes. Details of the limits of the possible range are sufficient. | None |
| 4. | Provide sensitivity analysis for the whole of its business but different types of sensitivity for different classes of FIs | None |
| 43c | Qualitative info required alongside quant. | Added: “and the reasons for such changes” | None |
| Para 44 | Nature and extent of risks arising from FIs (Sensitivity continued) | 44 scope clarification and guidance | Allows an entity to disclose a sensitivity analysis that they prepare internally such as Value-at-Risk (VaR). |

<table>
<thead>
<tr>
<th></th>
<th>Source</th>
</tr>
</thead>
</table>
| | CL25 Japanese Bankers Association  
CL10 German Accounting Standards Committee (DRSC)  
CL36 Organismo Italiano di Contabilità – OIC  
CL40 Nestlé  
CL43 Industrie-Holding  
CL47 International Swaps and Derivatives Association (ISDA)  
CL47 International Swaps and Derivatives Association (ISDA) (not repetition)  
CL49 Conseil National de la Comptabilité (CNC)  
CL54 Deutsche Bank  
CL67 Italian Banking Association (ABI)  
CL67 Italian Banking Association (ABI) |
| Notes added for guidance purposes about the allowance to use other methods plus examples | 1. Method allowed even if it only measures potential for loss | None |
| 2. Allows historical observations and weightings applied to observations within that period to be disclosed. Also asks for an explanation of how options are dealt with in calculations and permits Monte Carlo probability distribution simulations | None |
| 43a additional disclosure | Additional disclosure: An explanation of the method in preparing and the main parameters and assumption | None |
| 43b additional disclosure | An explanation of the objective of the method used and its limitations that may result in the information not fully reflecting the FV of the assets and liabs. Involved. | CL40 Nestlé |
| Para 45 Nature and extent of risks arising from FIs | Clarification | Adds an example of where the risk might be unrepresentative: “for example because the year end exposure does not reflect the exposure | None |
### [Other market risks disclosures]

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional requirement</td>
<td>To disclose the fact that it is unrepresentative and the reason it believes it is unrepresentative</td>
</tr>
<tr>
<td>45a and b deleted and merged into 43</td>
<td>Deleted</td>
</tr>
</tbody>
</table>

**Para 46 Capital**

| CL10 German Accounting Standards Committee (DRSC) |
| CL16 Grant Thornton International |
| CL17 Syngenta International AG |
| CL18 London Investment Banking Association (LIBA) |
| CL20 Association of British Insurers (ABI) |
| CL21 Deloitte Touche Tohmatsu International |
| CL32 South African Institute of Chartered Accountants (SAICA) |
| CL36 Organismo Italiano di Contabilità – OIC |
| CL38 Institute of Chartered Accountants in England & Wales (ICAEW) |
| CL38 Institute of Chartered Accountants in England & Wales (not repetition) |
| CL38 Institute of Chartered Accountants in England & Wales (not repetition) |
| CL49 Conseil National de la Comptabilité (CNC) |
| CL57 Swiss Reinsurance Company |
| CL60 Royal Bank of Scotland Group plc |
| CL61 Consiglio Nazionale dei Dottori Commercialisti and the Consiglio Nazionale dei Ragionieri |
| CL62 Foreningen af Statsautoriserede Revisorer (FSR) |
| CL64 Institut der Wirtschaftsprüfer (IDW) |
| CL65 Association of Corporate Treasurers |
| CL68 Nicki L. Tillinghast |
| CL69 International Organization of Securities Commissions (IOSCO) |
| CL74 100 Group |
| Para 47 | Capital [Qualitative information] | Deleted | CL36 Organismo Italiano di Contabilità – OIC  
CL38 Institute of Chartered Accountants in England & Wales  
CL61 Consiglio Nazionale dei Dottori Commercialisti and the Consiglio Nazionale dei Ragionieri  
CL68 Nicki L. Tillinghast  
CL83 Group of North American Insurance Enterprises |
| --- | --- | --- | --- |
| Para 48 | Capital [how capital is managed] | Different for regulated and non-regulated entities. Inappropriate in a financial instruments standard. | Deleted | CL16 Grant Thornton International  
CL18 London Investment Banking Association (LIBA)  
CL38 Institute of Chartered Accountants in England & Wales (ICAEW)  
CL38 Institute of Chartered Accountants in England & Wales (not repetition)  
CL47 International Swaps and Derivatives Association (ISDA)  
CL50 PricewaterhouseCoopers  
CL61 Consiglio Nazionale dei Dottori Commercialisti and the Consiglio |
<table>
<thead>
<tr>
<th>Para 49</th>
<th>Effective date</th>
<th>Guidance / clarification</th>
<th>Added detail about early application – comparative information for nature and extent of risks arising from financial instruments not required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Para 50</td>
<td>Supersedes IAS 30</td>
<td>Deleted</td>
<td>Allows an exemption from presenting certain comparative information if the Standard is early adopted specifically paras 31 – 42: The Nature and Extent of Risks Faced</td>
</tr>
<tr>
<td>New para</td>
<td>Exemption</td>
<td>Additional exemption guidance</td>
<td>Allows an exemption from presenting certain comparative information if the Standard is early adopted specifically paras 31 – 42: The Nature and Extent of Risks Faced</td>
</tr>
<tr>
<td>General comments</td>
<td></td>
<td>Clearer guidance about where balances are allowed to be shown aggregated e.g. para 43; application guidance notes</td>
<td>Clearer guidance about where balances are allowed to be shown aggregated e.g. para 43; application guidance notes</td>
</tr>
</tbody>
</table>
Appendix J Tests for relevance, understandability and fair representation

As stated in section 7.5.2, various tests were performed to gauge whether the type of comment had an impact on the results. The proposed amendments were further classified into three sub-categories: relevance; understandability; and fair representation. It was noted that the majority of comments related to understandability were concerned with presentational and grammatical amendments. The comments associated with relevance were informational changes and commonly asking for the deletion of requirements because they lacked relevance. Comments related to fair representation tended to be more general and combine the grammatical/presentational with the more substantive. The primary difference between the fair representation changes and the others tended to be the level of absoluteness. Rather than stating a change needed to be made because the standard was incorrect, incomplete, needed amendment for accuracy or changing because of a lack of relevance, these proposed changes were asking the standard setter to consider making changes to ease the burden of adopting the requirement and allowing a fairer representation of events, transactions, processes and management activities.

Therefore, in (overly-\textsuperscript{211}) simplistic terms relevance and fair representation were predominantly changes in substance and understandability changes were commonly those of presentation. If there is an argument that the results are skewed towards adding significance to changes at the margins (i.e. insignificant changes to the standard) then this analysis might help to cast more light on the issue. The results of the analysis are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Relevance</th>
<th>Understandability</th>
<th>Fair representation</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROF ACCG</td>
<td>0.5117</td>
<td>1.2457</td>
<td>-0.3727</td>
</tr>
<tr>
<td>PROF FIN INST'NS</td>
<td>0.5189</td>
<td>1.2622</td>
<td>-0.4710</td>
</tr>
<tr>
<td>PROF OTHER</td>
<td>0.5012</td>
<td>1.1630</td>
<td>-0.2705</td>
</tr>
<tr>
<td>AUDITOR</td>
<td>0.2311</td>
<td>0.4834</td>
<td>-0.5952</td>
</tr>
<tr>
<td>PREPARERS</td>
<td>0.7236</td>
<td>1.6298</td>
<td>-0.5801</td>
</tr>
<tr>
<td>UK</td>
<td>-0.3727</td>
<td>-2.1347</td>
<td>-0.1974</td>
</tr>
<tr>
<td>EUROPE (EXCL UK)</td>
<td>-0.0382</td>
<td>-0.1852</td>
<td>0.3352</td>
</tr>
</tbody>
</table>

\textsuperscript{211} The statement 'overly' reflects the discussion in section 7.5.1 about the wording changes not being purely about correcting spelling or grammar mistakes but instead about changing issues of substance in many cases. In one or two cases, fundamentally changing the interpretation of the paragraph.
The results indicate that comments related to proposed amendments for relevance issues arising from the UK carry significance to the 5% level (10% in original analysis presented). Again, the direction indicates that this is a negative relationship. None of the other models showed any significance to comments arising from the UK but interestingly, the comments related to fair representation showed a positive relationship. The results indicate that comments related to proposed amendments for understandability issues arising from preparers, from Europe and from the rest of the world were significant. Preparers’ comments had a significant effect to the 10% level but this relationship was negative. Comments arising from Europe (excluding the UK) were highly significant and the direction was positive. Comments arising from the rest of the world were significant to the 10% level and negative. The results showed no level of significance to fair representation issues. It is worth noting that in each model, but especially understandability, the R²s are low.

There are interesting parallels between these results and the results shown above. There appears to be evidence from every model that there is a negative relationship between comments from the rest of the world and the relative chance of success. For the purposes of this project, the most interesting result is that at the comment letter stage there appears to be little indication that any participant in the standard setting process has greater relative power. The only possible issue is the possible negative relationship between preparers understandability proposed amendments and their relative success however the number of observations and the type of comments being raised (normally of a marginal nature rather than a substantive one) lead to the tentative conclusion that the results presented in the chapter above are relatively robust. These results appear to concur with the original presented results above in that they indicate that the process is fair and free from bias at a respondent group/coalition level.