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Issues in the Recognition versus Disclosure of Financial Information Debate

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Abstract

Empirical evidence from the academic literature on capital market effects of financial information placement (i.e., recognition on the face of the primary financial statements versus disclosure in the notes to the financial statements) is not straightforward. Therefore, the purpose of this paper is to contribute to the recognition versus required disclosure debate in a standard-setting context by exploring possible reasons for perceived differences between recognized and disclosed amounts. These differences, in our view, arise due to demonstrated auditors' greater tolerance for misstatement in disclosed amounts, allowed non-compliance with disclosure requirements even in strong enforcement regimes, lesser care that preparers of financial statements devote to disclosures relative to recognized items as well as behavioural factors and differential processing costs related to the users of financial information. We believe that these arguments strengthen the case for the general preference for the recognition of financial information in the standard-setting context. The original scientific contribution of this paper is to systematically identify the reasons for the differences between recognized and disclosed amounts in financial statements. As such, this paper may provide a suitable basis for the justification of certain conceptual changes in the field of international accounting standards that are currently underway.

Key words: Auditing, disclosure, financial information, notes, recognition

Introduction

The question regarding whether users of financial information process amounts disclosed in the notes to the financial statements and those recognized on the face of the primary financial statements similarly is of interest to standard setters, regulators, financial statements preparers, auditors, and hence academics. Efficient market theory (EFM) suggests that the markets adopt a substance over form approach and incorporate all publicly available information, irrespective of the location in the financial report (i.e., whether the amount is recognized on the face of the primary financial statements or disclosed in the notes).¹

¹ It is worth noting that some disclosed items in financial reports are not recognized—and likely never will be—because they cannot be expressed in numbers or, more narrowly, in currency units. Examples include the qualitative description of accounting policies, a summary of inputs to the calculation of a recognized number, and a sensitivity analysis (Schipper, 2007, p. 301).

Yet some (value relevance) archival research suggests that, under certain conditions, note disclosures are less strongly associated with market values (of equity; i.e., share prices), such as Bernard and Schipper (1994), Aboody (1996), Davis-Friday, Folani, Liu, and Mittelstaedt (1999), Davis-Friday, Liu, and Mittelstaedt (2004), Ahmed, Kilic, and Lobo (2006), and Israeli (2015). Davis-Friday et al. (2004) suggested that investors perceive reliability differences between recognized and disclosed amounts, while Ahmed et al. (2006) argued that the differences are due to limited investor attention or processing costs (Bratten, Choudhary, & Schipper, 2013, p. 1185). In addition, Al Jifri and Citron (2009, p. 124) asserted that recognition may imply greater relevance,² in which users correctly assign lower weight to disclosed amounts. On the other hand, a few studies have suggested that, for particular classes of firms (for firms engaged in R&D: Al Jifri & Citron, 2009³) and for particular accounting items in question (pensions: Gopalakrishnan, 1994; leases: Bratten et al., 2013), the capital market participants perceive recognized and disclosed amounts equivalently, which is consistent with the efficient market hypothesis (EMH).

We can thus conclude that the empirical evidence from the academic literature on capital market effects of recognition versus disclosure in the notes to the financial statements is not straightforward. Therefore, the purpose of this paper is to contribute to the recognition versus required disclosure debate in the standard-setting context by exploring possible reasons for perceived differences between recognized and disclosed amounts. The original scientific contribution of this paper is to systematically identify the reasons for the differences between the amounts recognized and disclosed in the financial statements. As such, the paper may constitute a suitable basis for the justification of certain conceptual changes in the field of international accounting standards that are currently underway within the Conceptual Framework project and with the recently issued IFRS 16 *Leases*.

The paper has the following structure: It begins with recognition and disclosure as financial reporting concepts, proceeds

with limited attention and differential processing costs, and then explores auditor behaviour related to recognized and disclosed numbers. The final section concludes the paper.

Recognition and Disclosure as Financial Reporting Concepts

Although no extant academic theory of accounting or standard setting exists, both world's most important standard setters—namely the International Accounting Standards Board (IASB), which issues International Financial Reporting Standards (IFRS), and the Financial Accounting Standards Board (FASB), the accounting standard setter from the USA—articulate their theory of accounting and standard setting in their conceptual frameworks⁴ (Barth, Beaver, & Landsman, 2001, p. 78).

On 28 September 2010, the IASB and the FASB announced the completion of the first phase of their joint project to develop an improved conceptual framework for IFRS and US generally accepted accounting practices (GAAP). This announcement actually referred to the issuance of “Chapter 1: The objective of financial reporting” and “Chapter 3: Qualitative characteristics of useful financial information” from the improved conceptual framework. Chapter 2 was intended to deal with the reporting entity concept while Chapter 4 contains the remaining text of the IASB's *Framework for the Preparation and Presentation of Financial Statements* published in 1989.⁵ The project's overall objective was to create

² Relevant financial information is capable of making a difference in users' decisions. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both (IASB, 2010, para. QC6–7).

³ The paper exploits the unique UK regulatory framework in which accounting for goodwill moved from note disclosure to balance sheet recognition. According to Al Jifri and Citron (2009, p. 125), their paper adds to the literature in a number of ways. First, it studies the recognition versus disclosure issue in a new context—namely, that of goodwill accounting. Second, it investigates whether the relative importance of recognized and disclosed amounts varies by type of firm (i.e., whether or not a firm engages in R&D).

⁴ A conceptual framework can be seen as an attempt to operationalize the accounting theory (Higson, 2003, p. 62). Davies, Paterson, and Wilson (1999, p. 53, as cited in Higson, 2003, p. 63) defined a conceptual framework as a statement of generally accepted theoretical principles that form the frame of reference for a particular field of enquiry. In terms of financial reporting, these theoretical principles provide the basis for both the development of new reporting practices and the evaluation of existing ones. The IASB's framework can be interpreted as a given, external set of high-level principles or norms that reflect fundamental value judgments made by the Board. In the IASB's regulatory context, decisions regarding the identification, definition, and hierarchy of these high-level principles are made in the political sphere—that is, after considering constituents' views (Fülbier, Hitz, & Sellhorn, 2009, p. 462). Solomons (1986, p. 116, as cited in McKernan, 2007, p. 173) identified defence against politicization as one of the key functions of the conceptual framework for financial reporting. If there is a sound conceptual framework, then the basis for the standard-setting decisions can be more widely understood, not only by politicians but also by other market participants, and will hopefully make the actions of the standard setter more defensible (Boyle, 2010, p. 301). See Dye (2001) for discussion about the theory of disclosures.

⁵ The FASB's conceptual framework consists of Statements of Financial Reporting Concepts (SFASs). On 28 September 2010, the FASB actually issued SFAS No. 8 to replace SFAS No. 1 *Objectives of Financial Reporting by Business Enterprises* and SFAS No. 2 *Qualitative Characteristics of Accounting Information*.

a sound foundation for future accounting standards that are principles based, internally consistent, and internationally converged. Nevertheless, the IASB subsequently decided not to conduct the project in phases anymore and thus published a comprehensive discussion paper (DP) addressing possible changes to the Conceptual Framework in July 2013. In the light of comments received on the DP, in May 2015 the IASB published an exposure draft (ED)—a new draft of the Conceptual Framework—to gather comments from the public. The deadline for comments on this ED ended on 25 November 2015. When the conceptual framework project is completed, the IASB will have a complete, comprehensive, and single document called the Conceptual Framework for Financial Reporting (IASB, 2016b).

Paragraph OB3 of the IASB's Conceptual Framework for Financial Reporting from 2010 (henceforth Framework 2010) states that "the objective of general purpose financial reporting is to provide financial information that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity." Recognition is covered in Chapter 4 of the Framework 2010, where paragraph 4.37 states that:

recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition. It involves the depiction of the item in words and by a monetary amount and the *inclusion of that amount* in the balance sheet or income statement totals.

In addition to defining and describing recognized items, Framework 2010 states that disclosure is not a substitute for recognition (paragraph 4.37) and provides recognition criteria (paragraph 4.38), explaining that an item that meets the definition of an element should be recognized if:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- (b) the item has a cost or value that can be measured with reliability.

This implies that recognition is actually a special case of financial reporting disclosure, restricted to items that meet certain criteria⁶ (Schipper, 2007, p. 304). In contrast to the detailed treatment of recognition, IASB's Framework 2010 hardly mentions disclosures in the notes and does not provide their definition. Nevertheless, more information about the

content of the notes can be found in IAS 1 *Presentation of financial statements*. Paragraph 10 of IAS 1 states that the complete set of financial statements also comprises notes, containing a summary of significant accounting policies and other explanatory information. In addition, paragraph 7 says that notes provide narrative descriptions or disaggregations of items presented in the primary financial statements and information about items that do not qualify for recognition in those statements.

We can thus conclude that disclosures in the notes can be numerical (i.e., expressed in monetary amounts) or textual (verbal); this paper only deals with the issues related to numerical disclosures. Moreover, numerical disclosures could also provide disaggregation of the monetary amounts presented in the primary financial statements. In this case the amounts disclosed in the notes to the financial statements complement those recognized on the face of the primary financial statements, but this area of interactions between disclosure and recognition is beyond the scope of this paper. Consequently, it should be highlighted that this paper focuses on the amounts recognized on the face of the primary financial statements and the amounts disclosed in the notes to the financial statements as direct quasi financial reporting alternatives.⁷

According to Clor-Proell and Maines (2014), standard setters—at least implicitly—view recognized information as more useful than disclosed information because recognized information is presumably more relevant and/or reliable. This should not come as a surprise, because the Framework 2010 recognition criteria imply that the items that meet the definitions of financial statement elements but fail one or more of the recognition criteria should be disclosed in the notes, and the very likely criterion to matter for this distinction is reliability (Schipper, 2007, p. 303).

We agree with Schipper (2007, p. 311) that no general agreement exists with regard to either the construct of reliability itself or its measurement. Some appear to believe that reliability is the ability of information to be vouched for, or confirmed by, an external archival source. Others appear to believe that reliability means the item's measurement is characterized by a high degree of consensus among independent measurers (a notion that subsumes the first idea of reliability). Still others appear to believe that reliability

⁶ An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material, or supplementary schedules. This is appropriate when the knowledge of the item is considered relevant to the evaluation of the financial position, performance, and changes in financial position of an entity by the users of financial statements (Framework 2010, paragraph 4.43).

⁷ For example, Bratten et al. (2013, p. 1184) pointed out that, in their comparison study of recognized versus disclosed post-retirement benefit (PBR) amounts, Davis-Friday et al. (2004) did not control for differences in their information characteristics. For example, the PRB disclosures were ranges rather than point estimates for 122 of the 199 sample firms, while recognized PRB values were point estimates accompanied by information about underlying assumptions.

refers to the precision of measurement (which is related to but differs from the consensus-of-measurements notion of reliability). Because attempts to explain what reliability was intended to mean in the standard-setting context have proved unsuccessful, the IASB and FASB⁸ sought a different term that would more clearly convey the intended meaning. The term *faithful representation*, the faithful depiction in financial reports of economic phenomena, was the result of that search.⁹

To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral, and free from error (Framework 2010, QC12). The IASB and FASB claim that the term encompasses the main characteristics that the previous frameworks included as aspects of reliability, so the term *reliability* disappeared from “Chapter 3 Qualitative characteristics of useful financial information” of the IASB’s Framework 2010. Nevertheless, since the term *reliability* was still used in some recent accounting literature (e.g., Clor-Proell & Maines, 2014; Kadous, Koonse, & Thayer, 2012; Knauer & Wöhrmann, 2016), we decided to use it in this paper as well.

One rationale for disclosing monetary amounts in the notes instead of recognizing them on the face of the financial statements is that information is less reliable due to significant uncertainty associated with the measurement of the monetary amount (Johnson & Storey, 1982). For example, opponents to expensing stock compensation (i.e., as recognized in the income statement) often argued in the past that the estimates arising from the fair-value method used in FASB’s Statement of Financial Accounting Standards (SFAS) No. 123R *Share-based payment* and IFRS 2 *Share-based payment* are unreliable (Malkiel & Baumol, 2002), that is contain considerable measurement (estimation) uncertainty. Given this rationale, reliability could thus determine information location (Libby, Nelson, & Hunton, 2006, p. 534).

Nevertheless, accounting standard setters may sometimes make monetary information location decisions for other reasons (Bernard & Schipper, 1994). Schipper (2007, p. 302) stated that “it seems implausible that a standard setter would not require the recognition of highly reliable items unless those items do not meet the definitions of financial statement

elements”; yet former FASB members have indicated that the decision to allow disclosure rather than recognition has been driven by political pressure in some cases (e.g., Beresford, 1996; Beresford, 1997). This suggests that standard setters’ information location decisions can be influenced by factors other than those described in the conceptual frameworks (Libby et al., 2006, p. 534).

Moreover, in our opinion, the concept of limited attention and differential processing costs (discussed in the next section) and auditor behaviour related to recognized and disclosed numbers (discussed in the subsequent section) strengthens the case for the preference for recognition in the standard-setting context.

Limited Attention and Differential Processing Costs

Hirshleifer and Teoh’s (2003) paper represents a step towards bridging what appears to be an increasingly wide gap between the views of many accounting and finance researchers (specifically, the views of hard core believers in market efficiency) and the views of just about everyone else in the world with respect to the perceived efficiency of capital markets (Lambert, 2003, p. 387). Their approach departs from theories in assuming that users of financial information—more precisely, investors—have limited attention and processing power. Limited attention is a necessary consequence of the vast amount of information available in the environment and of limits to information-processing power. Attention must be selective and requires effort (Hirshleifer & Teoh, 2003, p. 339). In their model, due to the limits to investor attention, the information presented in prominent, easily processed form is assumed to be absorbed more easily than the information that is less prominent or that is only implicit in the public information set. Thus, (some) investors neglect relevant aspects of the economic environments they face. Although inattention might seem foolish as inattentive investors lose money by ignoring aspects of the economic environment, if time and attention are costly, such behaviour may be reasonable (see Barth, Clinch, & Shibano, 2003).

Hirshleifer and Teoh’s (2003) paper develops a theoretical model in which a nontrivial number of investors are inattentive (unsophisticated) and either miss important information disclosures entirely or systematically misinterpret their implications. In such a world, accounting measurement rules, earnings management activities, and discretionary disclosures have an impact on stock prices even when these features bear no relation to the underlying cash flows of the firm (Lambert, 2003, pp. 387–388). Moreover, these features have an impact despite the existence of attentive

⁸ Since 1980, the FASB has used the term *reliability* to describe information that is reasonably free from error and bias and faithfully represents what it purports to represent (FASB, 1980). However, in 2010, the FASB (as well as the IASB) replaced the term *reliability* with *representational faithfulness* to describe information that is complete, free from error, and neutral (FASB, 2010). Despite this change, according to Clor-Proell and Maines (2014), the term *reliability* still continues to appear in the FASB Codification (e.g., FASB ASC 820). For more on qualitative characteristics in the IASB’s Framework 2010, see Novak (2012).

⁹ Based on the current IASB’s Framework 2010, BC3.20–BC3.25.

investors who have the ability to “see through” them.¹⁰ The paper derives a link between reporting and disclosure decisions and stock prices and goes on to analyse how sophisticated managers would make reporting and disclosure decisions to exploit the inability of the market to price their firms “correctly”, thereby increasing the stock prices of their firms (Lambert, 2003, pp. 387–388).

One of Hirshleifer and Teoh’s (2003, p. 380) conclusions is that limited attention may help explain why investors are insufficiently sceptical of firms positioned to conceal liabilities, such as off-balance sheet contractual provisions (e.g., operating leases).¹¹ Limited attention may also help explain, without appealing to political or contracting constraints, certain peculiarities in the structure of accounting rules. In the age of information technology, it has become cheaper to require detailed reporting of numerous transactions (for a given level of resources devoted to auditing). Actual accounting reports differ from such a standard in ways that, from a pure reporting perspective, seem either irrelevant or harmful. For example, accounting rules permit aggregation, which “throws away” information. A limited attention approach suggests that, even from a pure reporting perspective, aggregation can make sense because investors may have trouble processing disaggregated information. Similarly, redundancy can be helpful when different presentations ease the processing of that information for different uses.

A similar theoretical paper by Barth et al. (2003) compared disclosure with three types of recognition: aggregate recognition with disclosure, separate recognition, and aggregate recognition without disclosure. They assume that investors

decide whether to acquire accounting expertise. In doing so, investors trade off the cost of expertise acquisition against informational benefits they obtain from understanding disclosures. They assume that the expertise acquisition is costly because understanding disclosures requires accounting expertise beyond what is needed to understand recognized amounts.

If information is disclosed only in the notes, users of financial statements have to expend time and effort to become sufficiently expert in accounting to know (a) that there are items not recognized on the face of the financial statements, (b) that there is information about those items in the notes, and (c) how to assess the note disclosures. Because gaining that expertise is costly, some users of financial statements (i.e., those whose perceived expertise acquisition costs are higher than perceived informational benefits) will not become accounting experts. Therefore, information that is merely disclosed may not be fully reflected in share prices.

When comparing the disclosure regime with the separate recognition regime, Barth et al. (2003) found that recognition always increases price informativeness because, in this regime, recognition results in the disclosed amount being freely available to all investors. However, when aggregation is part of the recognition, as it is in the aggregate recognition with or without disclosure regimes, the results are more complex. In particular, in the aggregate recognition with disclosure regime, they found that recognition of an accounting component that results in a higher (lower) quality recognized amount does not always result in greater (lower) price informativeness. The differences in how capital market participants use recognized and disclosed items are thus due to differences in processing costs.

Lambert (2003, p. 399) agreed that individual investors cannot possibly process everything or even pay attention to everything that is of potential relevance to the valuation of the firm. In such a world, summary statistics can be of value, even if their role is to reduce economic search costs and is unrelated to psychology reasons. The big questions are how important these effects are and what factors influence their importance.

In addition, as articulated by Bernard and Schipper’s (1994, as cited in Clor-Proell & Maines, 2014, p. 667) result of standard setters’ view toward recognition versus disclosure, users may rationally perceive that firms report the most important financial information on the face of the financial statements—that is, they believe that recognized information in general is more relevant and reliable (see the discussion on auditor behaviour below) than disclosed information. This perspective suggests that economic differences between recognized and disclosed numbers lead users to

¹⁰ The model assumes that, because attentive investors all have full information, they all calculate identical expected values. Inattentive investors are assumed to calculate the wrong expected value relative to the expected value calculated by attentive investors. Moreover, all inattentive investors calculate the same wrong value. Inattentive investors are assumed to utilize the same value for the residual variance of cash flows, as do attentive investors. As a result, they trade just as aggressively based on their (incorrect) assessment of the firm value as attentive traders do based on their correct assessment. In what sense are market prices inefficient in this equilibrium? They are inefficient in the sense that the price is not the same as it would be if everyone was attentive (Lambert, 2003, p. 392).

¹¹ Under the operating lease, the lessee does not recognize any lease asset or liability in the balance sheet. Nevertheless, in contrast, it is obliged to disclose future expected rental payments in the notes to the financial statements. For operating leases having initial or remaining non-cancellable lease terms in excess of one year, the following information shall be disclosed in the notes to financial statements: future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate, and for each of the five succeeding fiscal years as well as the aggregate for the periods beyond five years. The usefulness of only a lump-sum amount disclosure beyond five years is, in our opinion, questionable. For more on lease accounting, see Novak (2011).

weigh recognized information more heavily than disclosed information.

This is indeed demonstrated by Frederickson, Hodge, and Pratt (2006). They noted that the evolution of employee stock option (ESO) accounting in the framework of U.S. GAAP from the initial adoption of SFAS No. 123 to the passage of SFAS No. 123R encompassed three reporting environments for stock option expense: (1) voluntary note disclosure, (2) voluntary income statement recognition, and (3) mandated income statement recognition (Frederickson et al., 2006, p. 1089). They demonstrated that mandated income statement recognition, as required by SFAS No. 123R, leads to higher user assessments of reliability than either voluntary income statement recognition or voluntary note disclosure, options allowed under the “old” SFAS No. 123. Users view voluntary note disclosure as the least reliable reporting alternative. In addition, Choudhary (2011) documented that mandatorily recognized ESO values are more accurate when compared to voluntarily recognized ones.

Auditor Behaviour Related to Recognized and Disclosed Numbers

Libby et al. (2006) examined whether auditors are willing to tolerate more error in disclosed numbers than in recognized numbers, which should reduce the reliability of disclosed numbers. They reported two experiments that examine audit partners’ willingness to tolerate misstatements in recognized and disclosed amounts.¹² The results from the experiments indicated that auditors require much greater correction of misstatements in recognized amounts than they do for the same amounts that are only disclosed. Debriefing data showed that this effect is intentional. Although recognition increases expected client resistance to correcting the misstatement,¹³ auditors view recognized misstatements as more material than disclosed misstatements and indicate a willingness to pressure the client more to correct recognized

misstatements. Recognition also increases the amount of time auditors expend when making a correction decision.

These results suggest that auditors believe their misstatement-reduction responsibilities vary between recognized and disclosed amounts—at least in part because they view misstatements in disclosed amounts to be less material. To the extent that financial markets and contracts rely less on disclosed numbers, setting higher materiality thresholds for disclosed numbers could be viewed as consistent with current accounting and auditing guidance. Therefore, allowing more misstatements in disclosed amounts in such circumstances may be a rational response by auditors to the lower risk of litigation or reputation loss associated with disclosed amounts (Libby et al., 2006, p. 535). However, the lower reliability produced by auditors’ greater tolerance for misstatements in disclosed amounts may reduce the overall quality of information available to users. It is unclear whether such an effect was intended by regulators, particularly in cases in which disclosure has been allowed as a political compromise. These results have potential implications for the interpretation of prior research and for accounting standard setters and auditing regulators (Libby et al., 2006, p. 535).

From a financial-reporting research perspective, Libby et al.’s (2006) results indicate that prior findings of reliability differences between recognized and disclosed amounts may be caused, in part, by differences in the extent of misstatement reduction provided by auditors. Thus, accounting standard setters’ information-location decisions may to some extent be self-fulfilling prophecies with respect to information reliability. Accounting regulators might consider whether an unintended consequence of relegating information to the notes to the financial statements is that the reliability of such information could be reduced by the interpretations and actions of auditors. Similarly, decisions to require recognition may have a positive effect on information reliability because recognition encourages auditors to require the correction of detected misstatements¹⁴. Moreover, Bischof, Brüggemann, and Daske (2011) demonstrated that required

¹² One experiment reported data from 44 Big 4 audit partners and found variances in whether a misstatement relates to a stock-compensation expense that is recognized or disclosed. The other experiment reported data from 33 Big 4 audit partners and found variances in whether a misstatement relates to lease liability that is recognized (as a capital lease) or disclosed (as an operating lease). In both experiments, the researchers held constant the company’s economic circumstances, the sign, quantitative materiality, and certainty of the misstatement as well as client opposition to the correction of the misstatement (Libby et al., 2006, p. 534).

¹³ Results obtained by Clor-Proell and Maines (2014) suggested that preparers may resist the correction of recognized amounts more than disclosed amounts in part because they have invested more effort in estimating recognized amounts.

¹⁴ The effect of information location on post-audit misstatement depends on its effect on both managers and auditors. Libby et al. (2006) held constant the amount of the pre-audit misstatement and demonstrated that auditors tolerate more misstatements in disclosed amounts, producing greater post-audit misstatements in disclosed amounts. Pre-audit misstatements may not be constant in practice. As recognized amounts may be more important in valuation and contracting, client managers may face greater incentives to create pre-audit misstatements in recognized amounts than in disclosed amounts. Alternatively, managers may create more pre-audit misstatements in disclosed amounts in anticipation of laxer auditing. Future research should seek to better understand how information location affects the extent of pre-audit misstatement. See Clor-Proell and Maines (2014) for more about the case of contingent liability estimates for recognized versus disclosed liabilities.

disclosures are not adequately enforced and that, in their case banks, get away with substantial non-compliance with disclosure requirements.¹⁵

In addition, Clor-Proell and Maines's (2014) paper investigated whether the placement of financial information (recognition versus disclosure in the notes) influences pre-audit judgement and decisions of financial managers who prepare financial statements and who thus establish initial reliability of financial information. Using an experiment with corporate controllers and chief financial officers for contingent liability estimates, the researchers found that public company financial managers generally exhibit less cognitive effort and more bias for disclosure than for recognition. This difference appears to be associated with capital market pressures (i.e., forces exerted by different participants in the capital markets—namely, standard setters, users, and auditors/regulators) because these differences are smaller for private company managers. Furthermore, comparing preparers' estimates to those provided by preparers in an internal reporting setting reveals that public company financial managers exhibit a downward bias in their disclosed estimates, but not in their recognized estimates.¹⁶ In contrast, private company financial managers do not exhibit a bias in either their disclosed or recognized estimates.

Conclusions

In the framework of literature on capital market effects of recognition versus disclosure, we support Al Jifri and Citron's (2009, p. 123) conclusion that further research should investigate the extent to which the market assessment of recognized versus disclosed amounts depends on the accounting item in question, its method of valuation and processing through books of account, which determine the level of judgement and estimation, as well as the characteristics of the firm. For example, empirical results from Bratten et al. (2013) suggested that recognized and disclosed amounts are

not treated differently by capital market participants¹⁷ in the lease setting, in which the disclosed amounts (in the notes to financial statements) are reliable and the disclosed information is readily identifiable and easily processed.

Nevertheless, capital market participants are not the only nor the most dominant capital providers in Europe. According to Cascino et al. (2014), virtually all European companies rely on bank loans and trade creditors for capital, and these jointly represent around 70% of the total liabilities in the typical balance sheet. Therefore, capital providers are not homogeneous, and their information needs differ systematically. Cascino et al. (2014) also found that experimental and archival evidence clearly documents that investors tend to ignore or "mis-evaluate" relevant information; furthermore, even professional equity investors may base their decisions on sub-optimal information and decision rules. For example, Hirst, Hopkins, and Whalen (2004) documented that even bank analysts, who are usually considered the most sophisticated users of financial reporting data, process recognized and disclosed information differently. Therefore, these behavioural and processing costs aspects are, in our opinion, even more prominent for non-sophisticated users of financial statements, such as individual investors. Hence, in our opinion, the information location in any case indeed matters.

As different stakeholders try to influence the information-location decisions (recognition versus disclosure) by the standard setters based on considerations other than those described in the conceptual frameworks, it seems that they believe that the information location in practice really matters. Our paper suggests a couple of reasons for the perceived differences between recognized and disclosed amounts. We believe that the relegation of amounts to the notes to the financial statements generally reduces informativeness of financial reports, especially for non-sophisticated users, and reduces the reliability of financial information. In our opinion, the preparers of the financial statements also generally take less care about disclosures relative to recognized items, mainly because of the inadequate auditor pressure, although Clor-Proell and Maines's (2014) findings indicated that there could be a difference between the public company and private company preparers. Libby et al. (2006) demonstrated auditors' greater tolerance for misstatements in disclosed amounts, whereas Bischof et al. (2011) revealed that sometimes the preparers get away with substantial non-compliance with disclosure requirements, even in Western European countries with supposedly strong enforcement regimes.

¹⁵ On 1 July 2008, the IASB introduced an option to retroactively change the fair value measurement of trading financial assets (apart from derivatives) and AFS assets into amortized cost measurement, with write-downs recognized only for other-than-temporary impairment losses. By reclassifying such financial assets, a financial institution could forgo the recognition of unrealized fair value losses deemed to be temporary and thus increase its financial result as well as its regulatory capital during market downturns. Nevertheless, almost two-thirds of the reclassifying banks did not fully comply with the simultaneously introduced IFRS 7 disclosure requirements (Bischof et al., 2012).

¹⁶ Wiedman and Wier (1999) found that firms' unconsolidated subsidiary debt increased when the FASB requirement (FAS 94 Consolidation of all Majority-Owned Subsidiaries) changed from disclosure to recognition, suggesting the understatement of the previously disclosed amount by the preparers.

¹⁷ Altamuro, Johnston, Pandit, and Zhang's (2014) empirical study provided evidence that the current off-balance sheet treatment of operating leases does not result in them being ignored in credit assessments by banks and credit rating agencies, which could be labelled as sophisticated users of financial statements.

We believe that all these factors strengthen the case for the general preference for recognition in the standard-setting context, as manifested in the recently issued IFRS 16 *Leases*, which introduced a single lessee accounting model and requires a lessee to recognize assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognize a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments (IFRS 16.IN10). The distinction between off-balance sheet lease arrangements (i.e., operating leases) and finance leases, which IAS 17 *Leases* defined as the leases that transfer to the lessee substantially all the risks and rewards incidental to the ownership of the leased asset and hence require recognition of lease payment obligations in the lessee's balance sheet, is therefore abolished.

In addition, it is worth mentioning that the note disclosures are due to both the increasing quantity ("disclosure overload") and quality aspects recently receiving a lot of attention in the accountancy community. For example, in July 2012, the European Financial Reporting Advisory Group (EFRAG) and the national standard setters of France, Autorité des Normes Comptables (ANC), and the UK, Financial Reporting Council (FRC), issued a discussion paper entitled *Towards a Disclosure Framework for the Notes*. It emphasized that a disclosure framework should contain a clear definition of the purpose of the notes, which should drive what (financial) information should be included in the notes and what belongs elsewhere. The FASB from the US launched the disclosure framework project in July 2009 and, in July 2012, issued Invitation to Comment—Disclosure

Framework (FASB, 2016), a document very similar to the joint discussion paper of EFRAG, ANC, and FRC.

The IASB formally added a short-term initiative on disclosure to its work program in December 2012 as a part of its response to its Agenda Consultation 2011. The objective of the initiative was to explore opportunities to see how those applying IFRS can improve and simplify disclosures within the existing disclosure requirements. In implementing this initiative, the IASB undertook a constituent survey on disclosure and held a disclosure forum designed to bring together securities regulators, auditors, investors, and preparers. The IASB subsequently issued its Feedback Statement Discussion Forum—Financial Reporting Disclosure in May 2013, which outlined the IASB's intention to consider a number of further initiatives, including short-term implementation and research projects (Deloitte, 2016). Currently the agenda contains one implementation project and two research projects. The implementation project is entitled *Materiality*, in which the IASB considers how materiality is applied in practice in IFRS financial statements; it has tentatively decided to provide guidance on the application of materiality. The first research project is entitled *Principles of Disclosure* and aims to identify and develop a set of principles for disclosure. The second research project is entitled *Standards-level Review of Disclosures* and aims to develop a drafting guide for the IASB to use when setting disclosure requirements in new and amended standards (IASB, 2016c). All these activities are thus directed to address the "lack of both theory and conceptual guidance for determining the purpose of the required note disclosures" (Schipper, 2007, p. 310) that was also clearly documented in this paper.

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Dejavniki v razpravi o pripoznavanju računovodskih informacij v primerjavi z njihovim razkrivanjem

Izvleček

Empirični dokazi iz akademske literature o učinkih položaja računovodskih informacij, tj. o pripoznavanju v okviru temeljnih računovodskih izkazov v primerjavi z razkritjem v pojasnilih k računovodskim izkazom, na kapitalske trge niso enoznačni. Zato je namen tega članka prispevati k razpravi o pripoznavanju v primerjavi z razkrivanjem v okviru oblikovanja računovodskih standardov z raziskovanjem možnih razlogov za zaznane razlike med pripoznanimi in razkritimi zneski. Te razlike se po našem mnenju pojavljajo zato, ker so revizorji bolj tolerantni za napačne navedbe v razkritjih, ker se dopušča neskladnost z zahtevami o razkritjih tudi v striktnih režimih uveljavljanja pravnih določil, ker so pripravljavci računovodskih izkazov pri razkritjih manj skrbni kot pri pripoznanih postavkah, pa tudi zaradi vedenjskih dejavnikov in razlik v stroških procesiranja informacij pri uporabnikih računovodskih informacij. Zato smo prepričani, da vsi ti argumenti krepijo splošno preferenco za pripoznavanje računovodskih informacij v okviru oblikovanja računovodskih standardov. Izvirni znanstveni prispevek tega članka je sistematična opredelitev razlogov za razlike med pripoznanimi in razkritimi zneski v računovodskih izkazih. Članek je tako lahko primerna podlaga za utemeljevanje konceptualnih sprememb na področju mednarodnih računovodskih standardov, ki so trenutno aktualne.

Ključne besede: revidiranje, razkrivanje, računovodske informacije, pojasnila, pripoznavanje