

**EFRAG Short Discussion Series**  
**THE USE OF INFORMATION BY CAPITAL PROVIDERS**  
**IMPLICATIONS FOR STANDARD SETTING**



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# Introduction



- 1 The objective of financial reporting is to provide information about an entity that reflects the results of management's stewardship and is useful to a wide range of users in making what are often fundamentally different economic decisions. To meet this objective it is critical to understand what information is useful, and whether the same information is equally useful for all users for investment decisions and stewardship-related decisions.
- 2 After receiving strong support from European constituents in response to its consultation on proactive work, EFRAG launched a proactive project in 2011 to understand how capital providers use financial statements. At the same time the Research Committee of the Institute of Chartered Accountants of Scotland (ICAS) was considering a project in this area, recognising the need to step back from current events and consider whether financial reporting is in fact serving the needs of users.
- 3 For their respective projects, EFRAG and ICAS identified the need first to take stock of the existing knowledge accumulated through academic research on the use of information by capital providers. They, therefore, joined forces to commission an international team of academics to undertake a comprehensive literature review on this issue. The resulting academic literature review was published in December 2013 by EFRAG and ICAS.
- 4 As a second step in its proactive project, EFRAG decided to publish this short paper summarising the implications for standard setting following from the findings of the academic literature review. Although this paper is published by EFRAG, the international team of academics, having performed the literature review, have agreed that the conclusions reached in this paper are in accordance with the findings of the literature review.


## Summary of reported findings



- 5 This paper – on the implications for standard setting of the academic literature review – is based on the premise that financial statements should address the needs of capital providers, while simultaneously considering the costs to preparers. With this starting point the paper infers some implications for standard setting from the academic literature review published by EFRAG and ICAS. To summarise, the main findings are:
- (a) Evidence is scarce on how information in financial statements is used – particularly by some groups of users. Given the lack of evidence on how financial statement information is used, standards would to some extent have to be based on assumptions and beliefs about what is useful information.
  - (b) Although some information is useful for both valuation and the assessment of stewardship, there are areas where the two objectives do not coincide. When preparing guidance, standard setters may therefore in some situations have to prioritise between information that is most useful for predicting future cash flows and information that is most useful for assessing stewardship. Alternatively, standard setters could choose only to provide very general requirements that are useful for meeting both objectives.
  - (c) Capital providers have diverse information needs. It will not be possible to meet the needs of all types of users simultaneously. Accordingly, standard setters may have to decide how to balance these interests or decide to focus on a specific subset of users when developing new standards. This could be done at a framework level or on a standard-by-standard basis. Alternatively, standard setters could choose to address only general needs of users and allow preparers to provide additional information tailored to those specific groups of users that are considered most relevant in the particular circumstances.
  - (d) Professional equity investors often base predictions of future cash flows on information in the statement of profit or loss rather than information in the statement of financial position. This could either indicate that the content of the statement of financial position is currently not adequate for predicting future cash flows, or it could indicate that users generally consider information about past performance to be better for predicting future cash flows than information about an entity’s resources and claims. As the latter might be the case, standard setters may choose to pay attention to the effects on the statement of profit or loss, including its ability to be used for prediction of future cash flows, when setting standards.



- (e) Some groups of capital providers, such as professional equity investors and debt providers, tend to prefer information reflecting 'persistent' or 'recurring' earnings. The academic literature review does not provide evidence on whether these users prefer to remove non-recurring items from the 'bottom line' themselves or want the management of an entity to do this, for example, by introducing a subtotal for 'recurring' earnings. If requirements to present subtotals for 'recurring' earnings are not introduced, standard setters could consider that users should be provided with information to assess 'recurring' earnings. While professional equity investors may want information about recurring earnings, standard setters may, however, also bear in mind that one study suggests that professional analysts may be misled by pro-forma earnings where 'one-off' items are typically excluded.
- (f) Disclosures in notes are not given the same degree of attention as figures recognised in the primary financial statements. Accordingly, standard setters may want to consider not only what information to present, but also how and where to present it.
- (g) The current distinction between profit or loss and other comprehensive income is relevant for investors because they place different weights on the respective line items when making decisions. Standard setters may therefore want to consider maintaining the distinction.
- (h) For certain classes of assets, measurement at fair value is preferred to historic cost. However, this does not apply when fair value is arrived at using unobservable inputs as part of 'mark to model' valuations. Therefore, standard setters may want to consider requiring certain assets to be measured at fair value, but may also consider limiting the use of fair value to situations where this measure can be determined using observable prices.
- (i) Capital providers need information to help them estimate risk, but the information needs are different for different types of capital providers.
- (j) Credit analysts consider what is currently off-balance sheet financing to be important. Standard setters may therefore consider how best to present such information (recognition versus disclosure).
- (k) Some groups of capital providers, such as private equity investors and trade creditors, rely mostly on intermediaries to provide them with information about an entity's financial situation. Standard setters may therefore consider tailoring information requirements to meet the needs of intermediaries rather than these groups of capital providers. This may enable standard setters to require presentation of more sophisticated information in the financial statements.

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- (l) Capital providers also receive information from sources other than the financial statements. Standard setters may therefore want to assess how information is distributed most effectively. This assessment could involve examining the benefits of providing information in the financial statements instead of communicating it through other channels.
  - (m) When assessing the costs of changing standards, standard setters may want to bear in mind that financial accounting information is used in a multitude of different contractual settings, such as lending agreements, managerial compensation contracts and financial market and product regulation. Changing financial accounting standards can cause significant adjustment costs. These costs can become substantial when contracts are inert, as is often the case with regulations.

6 The issues listed above are further explained in the following section.

# The implications



- 7 The IASB's approach to standard setting is to focus on users' needs, while simultaneously considering the costs to preparers. This appears from the IASB Conceptual Framework. The academic literature review published by EFRAG and ICAS in December 2013 examines what is known about capital providers' use of information. The academic literature review could thus provide some directions and implications for standards attempting to meet the needs of users, such as the IASB's standards. This section examines these implications.

## ASSUMPTION-BASED STANDARD SETTING

- 8 The academic literature review shows that evidence is scarce on how information in financial statements is used – particularly by some groups of users. Given this lack of evidence, standards would to some extent have to be based on assumptions and beliefs about what is useful information. As with all assumptions and beliefs, these could be wrong or simplified.

## NEED FOR PRIORITISATION OF OBJECTIVES

- 9 Paragraph OB4 of the IASB Conceptual Framework claims that:

To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.

- 10 Paragraph OB4 implies that information that is useful for assessing stewardship is also useful for predicting future cash flows. However, this assumption might be wrong.
- 11 Theoretical analyses summarised in the academic literature review reveal that although some information is useful for both valuation and assessing stewardship, this is not always the case. There are areas where the two objectives do not coincide. For example, information is useful for stewardship if it focuses on how well management has performed in the previous period, while information on factors beyond managers' control is generally unhelpful. On the other hand, such information can be highly important for valuation purposes. It is also sometimes preferable for information to have a conservative bias for stewardship assessment, while neutrality is favoured for valuation and financial decisions. Similarly, as discussed below, professional equity analysts may consider that inclusion of non-recurring items in totals and subtotals in the statement of profit or loss is complicating earnings and cash flow forecasts. However, non-recurring items may provide useful information about stewardship. In addition, whereas mark-to-market accounting may be desirable from a valuation perspective, it might not be from a stewardship perspective.




- 12 When preparing guidance, standard setters may sometimes have to choose between information that is most useful for predicting future cash flows and information that is most useful for assessing stewardship. Alternatively, standard setters could choose only to provide very general requirements that are useful for meeting both objectives.



## NOT POSSIBLE TO MEET THE NEEDS OF ALL TYPES OF USERS SIMULTANEOUSLY

- 13 The overarching finding of the academic literature review is that capital providers have highly diverse information needs. The implication of this for standard setting is that it may not be possible to meet the needs of all types of users simultaneously.
- 14 For example, while equity investors may be interested in both upside and downside risk, debt providers are primarily concerned with downside risk, because the upside is limited to the redemption value of the debt. As a result of these fundamental differences, the interests of debt holders and shareholders may conflict, particularly where shareholders and directors attempt to maximise the value of equity and not the value of the firm. Academic studies refer to this as the agency conflict of debt. The academic literature review explains that because the value of debt claims is generally more sensitive to decreases in firm value than to increases, debt contracts often treat gains and losses asymmetrically, and contracts include covenants triggered by decreases in the value of the firm, but not by increases. This creates more demand for conservatism in accounting from debt providers than from equity investors.
- 15 Standard setters may need to decide whether they prefer (1) to balance the different interests on a standard-by-standard basis, (2) to focus on a specific subset of users when developing new standards, or (3) to address only general needs of users and allow preparers to provide additional information tailored to those specific groups of users that are considered most relevant in the particular circumstances. The first strategy seems conceptually less compelling. The second strategy would require standard setters to choose what types of users should be considered. This includes deciding how narrowly the subset of users should be defined. For example, it appears from the academic literature review that an equity analyst is not just an equity analyst, as there are differences between buy-side and sell-side analysts and that the analyst's time horizon may also play a role.

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- 16 When making the decision on how to deal with capital providers' diverse information needs, standard setters may want to consider that the literature indicates that accounting may drive capital structure. Focusing requirements on particular capital providers' needs may therefore promote a specific capital structure in a jurisdiction. Standard setters may similarly bear in mind that focusing on a subset of users might not result in standards that result in equally useful information in all jurisdictions. The academic literature review shows that the legal environment (including enforcement) in which IFRS is applied differs between jurisdictions. The academic literature review therefore considers it unlikely that capital providers will use similarly financial statements of dissimilar quality, even if they are prepared using the same principles.



## CONSIDER THE EFFECTS ON THE STATEMENT OF PROFIT OR LOSS/IMPROVE THE USEFULNESS OF THE STATEMENT OF FINANCIAL POSITION

- 17 Evidence referred to in the academic literature review suggests that professional equity investors rely mostly on the statement of profit or loss when valuing equity using discounted cash flows models or P/E ratios. The same is the case for retail investors.
- 18 Based on what is currently reported in the statement of financial position and in the statement of profit or loss, this could indicate that professional equity investors find the information reported in the statement of profit or loss more useful for predicting future cash flows. That is, as currently reported, the presentation of past performance is considered more useful than the list of assets and liabilities.
- 19 This could either indicate that the content of the statement of financial position is currently not adequate for predicting future cash flows, or it could indicate that users generally consider information about past performance to be better for predicting future cash flows than information about an entity's resources and claims.
- 20 If the former is the case, standard setters may have to improve the information provided by the statement of financial position if they want to meet the needs of professional equity investors. If the latter is the case, standard setters might have to consider carefully the effects on the statement of profit or loss when preparing new standards. This includes paying attention to the statement's ability to be used for prediction of future cash flows.
- 21 Debt holders, who often provide more capital to large European companies than equity providers, rely heavily on the statement of financial position, particularly in terms of writing up the terms of the contract and designing the covenants. Standard setters should therefore not ignore the effects of standards on this statement. However, the academic literature review shows that adjustments are often made to balance sheet figures when debt providers employ financial covenants.



## PROVIDE INFORMATION TO ASSESS RECURRING EARNINGS

- 22 The academic literature review indicates that professional equity investors have a preference for information reflecting ‘persistent’ or recurring earnings. Transitory or non-recurring items are often removed from ‘bottom line’ GAAP numbers by these users. Similarly, the literature review indicates that some debt contracts require transitory items to be ignored when assessing compliance with debt covenants.
- 23 The academic literature review does not provide evidence on whether professional equity investors prefer to remove transitory items from the reported figures themselves or want the management of an entity to remove them, for example, by introducing a subtotal for ‘recurring’ earnings.
- 24 If no requirements for preparers to present ‘recurring’ earnings are introduced, standard setters may want to keep in mind that information enabling users to assess ‘recurring’ earnings could be required by other means.
- 25 Although professional equity investors seem to prefer ‘recurring’ earnings information, information about transitory and non-recurring items may be useful for assessing stewardship. In addition, standard setters may want to keep in mind that one study suggests that professional analysts may be misled by pro-forma earnings where ‘one-off’ items are typically excluded.



## PLACEMENT MATTERS

- 26 The reviewed academic literature shows that placement matters. Disclosures in notes are not given the same degree of attention as recognised figures (although more recent studies indicate that when analysts do go through the process of adjusting the footnote data as if it were recognised, they attach greater weight to it).
- 27 Accordingly, standard setters may not only want to consider carefully what information to require, but also how and where it should be presented.



## DISTINCTION BETWEEN PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME IS RELEVANT

- 28 Academic literature on other comprehensive income concludes that reported figures in other comprehensive income are less relevant to investors than net income. This seems to indicate that the different parts of the comprehensive income statement are not considered equally relevant. Standard setters may therefore decide to maintain the distinction.



## FAIR VALUE MEASUREMENT IS USEFUL SOMETIMES, SOMETIMES NOT

- 29 Currently most standards make use of both fair value measures (or other current measures) and cost based measures. The academic literature review shows that for professional investors there is some evidence that fair value is preferred to historic cost for liquid non-operating assets, but only when fair value is arrived at using observable market data. A theoretical study of fair value versus historical cost reports that mark-to-market accounting is most problematic (i.e. mark-to-market accounting may lead to inefficiencies by injecting artificial risk that degrades the information value of prices, and induces sub-optimal real decisions) for assets that are long-lived, illiquid, and senior (i.e. higher in ranking). In addition, fair value may not be suitable for liabilities as an experiment finds evidence that German investors were misled by fair value accounting for liabilities.
- 30 These results suggest that in some cases fair value does not provide information that is more relevant than historical cost. Yet currently the literature does not conclude whether the measurement in financial statements should solely be based on historical cost, to consider one extreme scenario, or to what extent it could be based on a mixed measurement model. It seems only to consider arguments in favour of and against e.g. fair value measurement.



## MULTIDIMENSIONAL RISK INFORMATION

- 31 The type of risk information needed by various users was found to be multidimensional in the academic literature review. The literature review discusses a few conflicts of interest related to information on risk that standard setters could consider and balance. For example, when insider ownership is high, firms face lower agency costs and there is a better alignment between managers and shareholders' goals. In this case, the alignment of interest between owners and managers potentially gives rise to an 'entrenchment risk' (i.e. the risk of wealth expropriation at the expense of minority shareholders). However, the academic literature review does not provide strong evidence on whether accounting information for this group should be different from other capital providers.



## INFORMATION NEEDED ON OFF-BALANCE SHEET FINANCING

- 32 The academic literature shows that credit analysts frequently adjust accounting figures by incorporating off balance-sheet financing via operating leases and securitizations, leading to significant adjustments to leverage ratios.
- 33 Standard setters may therefore consider whether such financing should remain off-balance sheet, or sufficient information about this should be provided in the notes to the financial statements to allow users to adjust leverage ratios.



## CONSIDER WHETHER TO ASSUME THAT SOME USERS RECEIVE INFORMATION THROUGH INTERMEDIARIES

- 34 The academic literature review indicates that trade creditors and private retail investors are not frequent direct users of financial statements. However, standard setters would probably conclude that financial statements should provide useful information for trade credit decisions and for retail investors.
- 35 Retail investors are important market participants as they provide liquidity, although they rarely engage in informed trading. These investors have less time, expertise and wealth to invest than their professional counterparts, so they do not use sophisticated valuation models and rely more on others to process financial statement data, such as public media and brokers.
- 36 Standard setters could therefore decide to assume that these groups of capital providers will receive the relevant information from financial statements via intermediaries instead of trying to make financial statements more accessible for these users. It may be that more sophisticated information could be provided in the financial statements if it is assumed that trade creditors and retail investors will receive the information after it has been processed and summarised by intermediaries that also consider information from other sources. In that case, standard setters might also think about developing and promoting training activities that focus on intermediaries like analysts, brokers and representatives from the public media.



## CONSIDER THE BENEFITS OF PROVIDING INFORMATION IN FINANCIAL STATEMENTS RATHER THAN BY OTHER MEANS

- 37 The academic literature review shows that financial statement information is neither used mechanistically by professional equity investors nor is it used in isolation. For these users direct company contact is often considered more important than the financial statements, yet such contact often revolves around accounting information. The academic literature review concludes that developing a financial accounting regime that provides a free-standing true and fair view of a company may accordingly not necessarily be the only objective. Instead, financial reporting could be designed to coexist with parallel information sources.



- 38 Before including requirements on information that particularly target the needs of professional equity investors (and in particular buy-side analysts), standard setters could therefore assess how users could most effectively receive information. This assessment could involve examining the benefits of providing information in the financial statements instead of communicating it through other channels. When examining these benefits, the competitive advantages of the financial accounting process could be taken into account. Financial accounting provides recurring, standardised, regulated and audited data and these features set it apart from other information sources with inherent weaknesses such as lack of reliability and verifiability.
- 39 One aspect standard setters may choose to consider is how to integrate the financial statements in the wider Integrated Reporting model. This reporting model may help businesses to make their communications as effective as possible.
- 40 Contrary to professional equity investors, many post-issuance contractual rights of lenders are specified in terms of audited financial statements alone and other sources of information are accordingly somewhat less important for lenders.

## **CHANGES TO ACCOUNTING STANDARDS MAY RESULT IN SIGNIFICANT RENEGOTIATION COSTS**

- 41 As mentioned above, certain contractual and regulatory users require financial accounting data that is conservatively biased. These users often have the option of amending their contracts and regulation if standards should change and become less conservative. However, this may result in significant renegotiation costs that should be considered by standards setters before amending standards





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