Financial Reporting in Challenging Times

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Background

The financial statements were and will always remain an important source of information for investors. During the Dot-Com Bubble, the increasingly absurd valuations and price-earnings ratios of Internet start-ups has taught us something; i.e. ultimately, all value creation should show up in the financial statements. If it takes too long, the income statement will indicate that the intangibles of a company are non-performing and impaired. Accounting must reflect the economic reality, even if that reality is harsh. IFRS standards helps achieve this objective, and therefore most countries around the globe, except for a few here and there have either adopted or converged to IFRS. In this article, we look at how IFRS standards have addressed the need of investors, as well as other financial reporting developments that complement financial statements in these challenging times.

Mounting Pile of Debts

The 2008 Global Financial Crisis was a result of sub-prime lending and the steep decline in the housing prices. One would have hoped that some lessons would have been learnt, however, that is not the case. The combined debt of consumers, banks, corporates and governments amounted to no less than 269% of GDP at the outbreak of the financial crisis. However, this has only worsened with time. Total debt continued to grow to a staggering 322% of global GDP in Q3 19, reaching close to $ 253 trillion. The easy monetary policy followed by central governments, led by tax benefits for debt financing, makes debt cheap. That overtime has led to a surge in debts.

The global economy is caught in a closed loop, that is hard to exit. Huge debts can only be serviced if interest rates remain low, and because interest rates are low, debt is high; therefore, it is very hard to return to a normal monetary policy. As we muddle through this sea of debts, we should be prepared for financial crisis along the way. From a financial reporting perspective, the question to ask is whether financial reporting adequately addresses this challenge.

Expected credit loss model

During the financial crisis, it became clear that the incurred loss model gave too much freedom for banks to postpone recognising inevitable loan losses for too long. The evergreening practices followed by banks, and the regulator turning a blind eye, has only served to prolong dealing with the problem. G20 wanted the International Accounting Standards Board (IASB) to address this problem. That gave birth to the expected loss model, which anticipates losses, by using historical trends and forward-looking data. Consequently, it will lead to much quicker loss recognition than was the case earlier. The introduction of the expected credit loss model has contributed to improvement of credit quality control systems in the banking system. More importantly, timely loan loss recognition will put a stop to reckless dividend distribution and crazy remuneration. Finally, timely loan loss recognition should lead to timely clean-up of banks' balance sheets.

Quicker loan loss recognition will lead to a faster hit of bank capital, so it is essential that banks are adequately capitalised. The fact that in India, Ind AS (Indian equivalent of IFRS) is not yet mandated for banks indicates the nervousness about the expected credit loss model, particularly, the inability of Indian banks to adequately capitalize themselves as a result of the impact the expected credit loss model is likely to create. It is important that Indian banks are adequately capitalized, before Ind AS is made mandatory for banks.

Leases

IFRS 16 Leases is the new model for accounting of leases. The Indian equivalent is Ind AS 116 Leases. The previous accounting model for leases required lessees to recognise assets and liabilities arising from finance leases but did not require lessees to recognise assets and liabilities arising from operating leases. The IASB, together with the US national standard-setter, the Financial Accounting Standards Board (FASB) (together 'the Boards'), initiated a joint project to improve the financial reporting of leasing activities under IFRS and US Generally Accepted Accounting Principles (US GAAP) in the light of criticisms that the previous accounting model for leases failed to meet the needs of users of financial statements. In particular, the existence of two different accounting models for leases, in which assets and liabilities associated with leases were not recognised for operating leases but were recognised for finance leases, meant that transactions that were economically similar could be accounted for very differently. The differences reduced comparability for users of financial statements and provided opportunities to structure transactions to achieve an accounting outcome.

Consequently, the Boards developed a new approach to lessee accounting that requires a lessee to recognise assets and liabilities for the rights and obligations created by leases. IFRS 16 requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months and for which the underlying asset is not of low value. The IASB concluded that such an approach will result in a more faithful representation of a lessee's assets and liabilities and, together with enhanced disclosures, greater transparency of a lessee's financial leverage and capital employed.

The lessee accounting model in the new standard reflects the economics of a lease because, at the commencement date, a lessee obtains the right to use an underlying asset for a period of time, and the lessor has delivered that right by making the asset available for use by the lessee. This is likely to bring more transparency to financial statements, particularly with respect to addressing the mounting debt problem, some of which were earlier kept out of the financial statements. The new standard has significantly impacted the balance sheet of entities that use operating leases, such as, airline, telecommunication and retail.

Alternate Performance Measures

In August 2018, Walmart acquired 77 percent Flipkart, an Indian-based eCommerce marketplace, for cash consideration of approximately $16 billion. Interestingly, Flipkart has never made a profit and unlikely to make any profits in the near term. In its 2019 annual report Walmart stated; "India has 1.3 billion people and an economy approaching $3 trillion, yet its eCommerce business is less than 3 percent. With our acquisition of Flipkart, we have positioned ourselves for growth in one of the top three markets in the world." Since the acquisition of Flipkart, Walmart has been burning billions of dollars to increase its' market share in India.

This eye-opening data point suggests that investors look beyond profit numbers and the balance sheet to make their investment decisions. Clearly, investors nurture very high hopes on future growth and profit potential of an entity. The valuation of $16 billion was not captured in the balance sheet of Flipkart, so therefore, the numbers in the financial statements of Flipkart probably played a limited role in its' market valuation. It highlights a trend towards a widening gap between book values as reflected in financial statements of companies and market values of companies. Given the increasing role of digital technology, differentiating knowledge, leadership and intangibles in the global economy, this will become more common place. This takes me to the moot point that financial statements; howsoever important, is not the only source of wisdom for investors.

No smoke and mirrors please

IFRS financial statements are prepared in accordance with a framework as well as audited, and therefore are reliable for assessing performance and facilitating comparison, both against different entities as well as over time within the same entity. On the other hand, alternate performance disclosures are not subjected to the same level of scrutiny. Entities may have an important story to tell beyond what is presented in financial statements. If, however, these measures are not used responsibly, they may mislead users. For example, it would be considered inappropriate to add-back expenses, such as share-based payments to employees, in a way that suggests that this is an unusual or non-recurring expense. For these reasons, disclosure of non-IFRS information or alternate performance measures is a key focus area for regulators around the globe.

Recent developments

In the recent European Securities and Markets Authority (ESMA) publication, 'Questions and Answers, Guidelines on APMs' issued on 17 April 2020, ESMA acknowledges entities' potential decision to disclose new or adjusted APMs in order to communicate the impact of the coronavirus outbreak on their operations. The Guidelines recommends the use of caution when adjusting existing APMs and/or when including new APMs related to the coronavirus. ESMA reminds entities to "carefully assess whether the intended adjustments or new APMs would provide transparent and useful information to the market, improve comparability, reliability and/or comprehensibility of APMs and of the financial information disclosed to the market".

The United States Securities and Exchange Commission (US SEC) staff, in its Disclosure Guidance: Topic No. 9, Coronavirus (COVID-19) provides some reminders to entities that elect to present non-GAAP measures, adjusted for the impact of the coronavirus outbreak. On application of the US SEC staff's guidance, it appears that non-GAAP measures that include estimates of lost revenue or adjustments to reflect what the performance or condition would have been without those effects are not appropriate.

The IASB ongoing project on Primary Financial Statements will also ensure greater transparency and discipline in the use of non-GAAP measures. Since non-GAAP disclosures are scattered, IASB intends to mandate companies to include their most important non-GAAP measures in a single note in the financial statements to make such information easier for investors to find. At the same time, the disclosure of the non-GAAP measures in this note will be subject to audit, as the note will be included within the financial statements. Additionally, a reconciliation must be provided between the non-GAAP figure and the closest IFRS subtotal. This will help investors better understand how the company arrived at a specific non-GAAP number.

Environmental, Social and Governance (ESG) reporting

There are many names to the same thing. ESG reporting is sometimes referred to as Sustainability Reporting, Corporate Social Responsibility Reporting, Climate Reporting, etc. The burning of the Amazon Forests, melting of the polar ice, and the climate catastrophes across the globe, has increased significantly the focus on sustainability reporting.

As per an article in the Financial Times *Defective Data is a Big Problem for Sustainable Investing (2019)*, there are at least 230 corporate sustainability standards initiatives across more than 80 sectors. This is unfortunate. A country like France has laid down very detailed ESG requirements in its legislation. The average size of a French annual report is almost 400 pages. In addition to the information overload, too many standards, does more harm than good. Consequently, there is an urgent need for consolidation of these standards. There should be one common global body that should take this initiative.

Broadly there are two types of reporting requirements. The first type of sustainability reporting such as those of the Global Reporting Initiative (GRI), are primarily focused on the external impact of a company on society and the planet, though these standards may also be relevant for investors who want to promote a green planet. It is hoped that such a reporting based on disclosures will encourage companies to behave responsibly to environment and society.

The report *Mapping India's Energy Subsidies 2020*, the Council on Energy, Environment and Water (CEEW) states that, "since 2017, government support for fossil fuels increased by 65 per cent while support for renewables declined by 35 per cent……India's subsidies to oil, gas and coal (INR 83,134 crore in FY 2019) are seven times more than the value of subsidies to renewables and electric vehicles." If the government itself subsidizes polluting industries, it is questionable whether such type of reporting will promote behavioural change in the corporate sector. Another example is that of the recent bond issue of the Saudi oil giant Aramco which was oversubscribed more than eight times! ESG reporting can help raise awareness about long-term sustainability issues, but legislation and financial incentives will ultimately drive the behavioural change. ESG reporting by global airline companies, will do little for environment, but if the cost of pollution is built into air-tickets, that would certainly do a lot more in reducing carbon emissions.

The second type of reporting are standards and frameworks such as those of the Sustainability Accounting Standards Board (SASB), the Climate Disclosure Standards Board (CDSB), etc which require a company to describe the potential financial impact of sustainability issues on the company and its future performance rather than on general public good. This type of standard is particularly important for companies that are sensitive to the financial effects of climate change; for example, the insurance industry, fishing industry, agriculture, beverage and water resources, etc. This type of information is essential for investors who want to form an opinion about the long-term viability of companies.

By and large, it is noticed, that ESG reporting has become an exercise in public relations rather than promoting a behavioural change. Take for instance the soft drinks manufacturers. They make tall claims on how they are adding healthy products in their portfolio and promoting consumers to pursue a healthier lifestyle. However, their hypocrisy is exposed when they oppose a sugar tax or a legislative change to label their beverages as unhealthy!! It is good that G20 actively promotes climate-related disclosures; but it would be many times better if they can get the G20 leaders to agree to introduce legislative changes and a mechanism of financial incentives and disincentives to reduce carbon emissions.