On the relevance of IFRS financial statements

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It is amazing what one can tell about a company from a deep and thorough analysis of its financial statements. Wayne van Zijl, a CA(SA) and a senior lecturer at Wits University, shares his views on IFRS.

As a financial accounting lecturer at Wits, I get excited in class while explaining how a keen-eyed chartered accountant can pick up things that, in all likelihood, accountants without detailed technical accounting knowledge would miss. With some dedication, IFRS can give one insight into even the management teams at the various companies.

Despite the billions spent each year both preparing and auditing financial statements, why do so many people question IFRS-compliant financial statements' relevance and usefulness? In this article I interrogate two common reasons given for IFRS' declining relevance, discuss two additional considerations and make some suggestions.

I usually hear the same two complaints about IFRS financials. Firstly, preparers and some auditors complain that IFRS financials are just so complex that they are now not understandable to their users. Secondly, preparers complain that IFRS requires so many adjustments that don't accurately reflect the business operations and need to be reversed by users.

Let's first look at the allegation of IFRS being too complex. If we look at a simple fish and chips shop, how complex would those financial statements be? Revenue, even under the new IFRS 15, is so straightforward I don't think even first-year accounting students would struggle to get the right answer. The same goes for short-term trade receivables and long-term loans. This simple business is straightforward and, consequently, so are the resultant financial statements.

Now contrast the fish and chips shop with the financial services industry or multi-national conglomerates. These companies often employ highly complex contracts designed to achieve specific risk-reward payoffs. Think back to financial engineering with straddles, strangles, valleys and a plethora of other structures. Many people struggle to understand the transactions. Can one then really blame IFRS for the resulting complex set of financial statements? I have selected extreme cases, yes, but the point remains. The complexity of financials under IFRS is often a function of how complex the underlying business operations and structures are.

In addition, I suspect that preparers and auditors often project the difficulty of preparing IFRS financials onto their assessment about the difficulty in reading and extracting useful information from financials. Making a cell phone is difficult, using one is easy.

Let's now look at the second complaint that IFRS adjustments distort the business's operations. A CEO recently said in an interview that if he borrows R100, how much does he owe. R100, obviously. But then argued that IFRS says that R100 must be fair valued and so all of a sudden, the "IOU" is not R100 anymore. This happens often. The statement is partially correct. The issue is that the context is absent. In a plain-vanilla loan of R100, the fair value is also R100, leading to the correct initial recognition of R100 (IFRS 9). If you lend R100 and agree to pay back R100 in two years, interest-free, then the case is not so straightforward. Here is where I think IFRS is great at helping us understand the underlying economics of what we are entering into.

Agreeing to repay someone R100 over two years, means that the value you are indebting yourself to now is only R88 (PV of R100 at n=2). So, you receive R100 today and have a liability of R88. In other words, if you had to pay someone else to take over that obligation at inception, you would only need to pay R88. This genuinely means you made a day one gain of R12 as cash increases by R100, but your liabilities increase by only R88 (income definition: a net increase in assets). This demonstrates that the company did receive a benefit in obtaining an interest-free loan. Simply recognising R100 at initial recognition and then derecognising the R100 liability after two years would not tell users if this benefit management was able to negotiate and the cost of borrowing money. IFRS's adjustments don't give nonsensical answers. Would you lend money to a third-party interest-free? Probably not.

I think the interest-free loan example reinforces my earlier point that IFRS is as complex as the transactions it must present to users. I think it also highlights that we are, perhaps, too quick to latch onto a complex example, get frustrated and then (mistakenly) use it to argue why IFRS is nonsensical in general. There are some peculiarities in IFRS that I question (they are usually anti-abuse mechanisms). But importantly, these are few and the exception rather than the norm. Tweet me @CCAAR_SOA_WITS with any examples you have of peculiar accounting treatments, and I will be happy to look at those with you.

While the two concerns discussed may be partially true, I think two other factors affect people's perception of IFRS's relevance. Firstly, users need to invest time in learning how to read IFRS financials. More importantly, they need to understand how to extract value from the financials (and this is not the same as knowing how to preparing financials). Secondly, there are now so many sources of both financial and non-financial information that IFRS financials are competing against. This results in a trade-off between the ease of use of the various sources and their depth of information and credibility.

IFRS's Conceptual Framework states upfront that it is meant for informed and diligent users (CF, 2.36). Comments that laypersons would not be able to understand IFRS are correct and by design. Reiterating my comment earlier, if a layperson cannot understand the underlying transactions, it is obvious that they would struggle to understand the financials. But would a layperson be able to compare high-level metrics from IFRS financials to make a decision that aligns with his or her competencies and ability? I think they would. They could compare base metrics such as profitability, assets, cash balances and cash flows. More sophisticated investors can dig deeper into the notes and use their existing economic and industry knowledge to interpret and analyse the financials to make more informed decisions in line with their competencies and ability. These users have the technical competencies, time, and motivation to do so.

What we should consider is whether the current providers of capital (users) would want to tip the scales of the trade-off between detailed financials and understandability more towards the understandability side. This may result in less detail but increase the financials' understandability to more laypersons. I question whether laypersons even want to interrogate financials, but this question leads us to the final point.

There has been a shift in the corporate reporting environment. Now, there are multiple sources of financial and non-financial information that are updated more regularly. The fast pace and globalisation also mean there are more investors to compete against, driving the demand for more information that is updated more regularly.

Examples include integrated, sustainability and environmental reports; company websites; stock exchange news services; financial press; XBRL and social media. These sources offer management teams great flexibility over what information to provide and how to present it. These sources are especially attractive to non-sophisticated users that do not have the skills, time, and motivation to dedicate to performing a thorough analysis of financial statements. They are also useful to sophisticated users to supplement the financial statements via both their ability to allow management to have their say and as these are updated more frequently. The trade-off of the greater frequency and understandability of these sources is that they are also less credible (un-audited), comparable and detailed than financials. For these reasons, I propose that IFRS financials are still fit for purpose.

In closing, IFRS, in general, results in financial statements that are as complex as the underlying operations of the company it is depicting. IFRS, in my opinion, does represent the economics of a company's transactions and events with limited exceptions. IFRS financial statements are not meant to be understandable by the laypersons – the layperson wouldn't understand complex businesses anyway. Sophisticated investors need detailed, accurate and credible information that is, currently, only provided by financial statements. These users need to spend time mastering how to read and interpret IFRS financials to extract value. I think we are perhaps missing a degree or diploma specifically designed to teach people how to use IFRS financials (not how to prepare them). It should teach people where to start, how to approach the analysis, industry-specific concepts to understand first and how to complement the analysis with other sources of information. Lastly, in the competitive global environment we find ourselves in, each reporting source has its place. One cannot expect one source to satisfy all one's needs.

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