Primary Financial Statements—
Literature Review

Academic and non-academic studies

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Purpose of the presentation

• To describe some of the academic and other research relevant to the Primary Financial Statements project.

— we reviewed academic and other studies for additional evidence on the issues we found in our desk research and outreach

— we examined studies that focused on possible improvements to the primary financial statements and segments

— we report findings that have a direct bearing on potential scope of the project

— we provide details for each study in the Appendix.
Summary of findings on possible improvements

**Statement(s) of financial performance**
- Users need more subtotals, disaggregation and structure than specified in IFRS Standards.
- Separating operating from financing activities is value relevant.
- Investors often don’t use OCI.

**Across primary financial statements**
- Aligning primary financial statements can add value.
- Allowing choice in reporting interest in the statement of cash flows hinders comparability.
- Primary financial statement information is used differently for different industries—eg banking, insurance and property.

**Segment reporting**
- Users would like more detail in segments notes.
## Statement(s) of financial performance improvements

<table>
<thead>
<tr>
<th>Research</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Libby et al (2013)</td>
<td>Reviews literature and provides a framework for understanding academic research on <strong>earnings</strong> presentation:</td>
</tr>
<tr>
<td></td>
<td>• users rely on disaggregation, but it is most useful if provided cohesively across all PFS</td>
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<tr>
<td></td>
<td>• suggests additional requirements to limit management opportunism.</td>
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<tr>
<td>Penman (2016)</td>
<td>Proposes redesign of <strong>all PFS</strong>:</td>
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<tr>
<td></td>
<td>• subtotals should separate operations from financing (and sustainable from that which is unsustainable)</td>
</tr>
<tr>
<td></td>
<td>• additional disaggregation (line items) in should provide information about future cash flows.</td>
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- Users need more subtotals, disaggregation and structure than specified in IFRS Standards.
- Separating operating from financing activities is value relevant.
Statement(s) of financial performance improvements, continued

- Users need more subtotals, disaggregation and structure than specified in IFRS Standards.
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<td>Barton et al (2010)</td>
<td>Examines investors’ use of performance measures in statement(s) of performance:</td>
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<tr>
<td></td>
<td>- EBITDA and operating profit are more relevant for valuation than revenue or total comprehensive income</td>
</tr>
<tr>
<td></td>
<td>- OCI is the least ‘value relevant’ of the measures studied.</td>
</tr>
<tr>
<td>Black et al (2016)</td>
<td>Documents non-GAAP measures literature to date:</td>
</tr>
<tr>
<td></td>
<td>- users find non-GAAP performance measures more informative than GAAP</td>
</tr>
<tr>
<td></td>
<td>- managers use non-GAAP measures strategically and increasingly exclude recurring items</td>
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<td>- additional regulation makes non-GAAP measures more informative and less opportunistic.</td>
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Improvements across primary financial statements

- Aligning primary financial statements can add value.
- Allowing choice in reporting interest in the statement of cash flows hinders comparability.
- Primary financial statement information is used differently for different industries—eg banking, insurance and property.

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<td>Penman (2016)</td>
<td>Proposes new design for all PFS:</td>
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<td>• require alignment between key subtotals</td>
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<td>• information is for common shareholders.</td>
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<td>Libby (2013)</td>
<td>Finds that users rely on disaggregation; most useful if provided cohesively across all PFS.</td>
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<td>Gordon et al (2016)</td>
<td>Examines current interest reporting choices in the statement of cash flows:</td>
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<tr>
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<td>• options hinder comparability; sometimes used strategically; some classification switching</td>
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<td>• overall, most entities report interest paid as operating, but this varies by country.</td>
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<tr>
<td>Imam et al (2008)</td>
<td>Studies use of valuation measures:</td>
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<td>• users attempt to make PFS information comparable; sell-side tailor PFS use by industry.</td>
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Studies by non-academic organisations
### Statement(s) of financial performance improvements

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<td>NZ XRB (2016)</td>
<td>Examines information needs in the NZ capital markets; says investors require more detailed financial statement information.</td>
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<td>EFRAG/ICAS (2016)</td>
<td>Finds that the demand for non-GAAP measures such as EBITDA supports calls for standardised performance measures.</td>
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| US SEC (2011)     | Finds  

- subtotals vary (18 different subtotals observed); clear picture of how derived often not in PFS or notes  
- some non-GAAP measures on the face  
- EPS—many alternatives—eg operating profit per share; normalised EPS; EPS before exceptional items; and EPS before restructuring, disposals, and other one-off items.  

- Users need more subtotals, disaggregation and structure than specified in IFRS Standards.  
- Separating operating from financing activities is value relevant.
Improvements across primary financial statements

- Aligning primary financial statements can add value.
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- Primary financial statement information is used differently for different industries—e.g. banking, insurance and property.

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<td>NZ XRB (2016)</td>
<td>Says NZ users want greater consistency in presentation or format.</td>
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<td>UK FRC (2012)</td>
<td>Recommends that entities use descriptions in statement of cash flows so that relationship to related items on other primary financial statements can be understood.</td>
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| US SEC (2011)  | Finds
  • presentation varies due to entity IAS 1 interpretation & country regulations
  • statement of cash flows—significant differences among entities, and 10 variations in the starting point for indirect method of operating cash flows. |
Segment reporting improvements

- Users would like more detail in segments note.

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<td>NZ XRB (2016)</td>
<td>Says NZ users want enhanced segment reporting.</td>
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Appendix
Additional details about each study
Barton et al (2010)

‘Which performance measures do investors around the world value the most—and why?’ (Barton, Hansen, and Pownall, *The Accounting Review*, Vol. 85, No. 3)

- **Summary**
  - **Sample:**
    - 19,784 firms, 46 countries (1996-2005)
  - **Some key points:**
    - no single measure dominates around the world
    - value relevance stronger in the middle of the statement of financial performance—EBITDA and Operating Profit
    - value relevance related to two underlying factors:
      - articulation with cash flows (positive association)
      - sustainability, smoothness, predictability (negative association, may reflect strategic earnings management).
Black et al (2016)

‘Non-GAAP reporting: evidence from academia and current practice’ (Black, Christensen, Ciesielski, and Whipple, Working Paper)

• Summary
  — Extensive literature review and some additional research.
  — Some key points:
    – investors pay more attention to non-GAAP than GAAP when looking for a summary performance measure
    – whether non-GAAP informs or is opportunistic has changed over time; on average non-GAAP is informative, with added regulation generally improving the quality of non-GAAP
    – managers increasingly exclude items that recur, and entity-specific adjustments are also emerging
    – the amount and type of non-GAAP measures varies by industry, with specific industries driving most of the occurrences and growth over time
    – managers and analysts both create non-GAAP measures.
Gordon et al (2016)


• Summary
  — Sample:
  — Some key points:
     – choice in presentation hinders comparability
     – classification that increases operating cash flows (OCF) is correlated with higher likelihood of distress; greater equity issuance; higher leverage; lower profitability
     – OCF-increasing classification switches occur when issuing equity.
Imam et al (2008)

• ‘The use of valuation models by UK investment analysts (Imam, Barker, and Clubb, European Accounting Review, Vol. 17, No. 3)

• Summary
  —Sample:
  —Some key points:
    – analysts’ model choices reflect desire to communicate with their investor clients; these vary by industry
    – use of PFS information varies by industry
    – users attempt to make entities’ primary financial statement (PFS) information comparable
    – users’ ranking of accounting variables:
Libby et al (2013)

‘Earnings presentation effects on managers and users behavior’ (Libby and Emett, ICAEW Information for Better Market Conference)

• Summary:
  — Literature review and framework for thinking about presentation.
  — Some key points:
    – disaggregation: managers do so strategically; users rely on it for additional information; informativeness limited unless disaggregations are provided cohesively
    – location: users differentially react to information depending on location; in part because location contains information, and also because it affects information processing costs.
Libby et al, continued

• Advice for standard setters:
  — don’t let the perfect be the enemy of the good (Voltaire)
  — instead of broad-reaching improvements, look for common-sense piecemeal improvements
  — for example:
    – increased disaggregation
    – increased comparability in subtotals by providing guidance that limits management’s opportunism.
Penman (2016)

- ‘The design of financial statements’ (Occasional Paper, Columbia Business School, Center for Excellence in Accounting and Security Analysis)

- Summary:
  — Some key points:
    - cohesion conveys information that needs to be brought to the fore
    - activities to do with business operations should be clearly distinguished from those financing the business
    - disaggregation should be about enhancing information about future cash flows
    - on-going income is distinguished from unsustainable income, and a forward-looking EPS is provided as an alternative EPS measure
    - totals in each financial statement should be designed to meet information needs of common shareholders.
EFRAG/ICAS (2016)

• ‘Professional investors and the decision usefulness of financial reporting’ (Cascino, Clatworthy, Osma, Gassen, Imam, and Jeanjean)

• Summary
  — Sample:
    – 81 investors from Europe and North America.
  — Some key points (for standard setters):
    – investors have different information needs, depending on whether the objective is valuation or assessing management
    – they generally find the income statement more useful than the balance sheet
    – the demand for non-GAAP measures such as EBITDA supports calls for development of standardised income statement performance measures.
NZ XRB (2016)

- ‘Are financial reports meeting user needs?’ (commissioned research carried out by Massey University)

- Summary
  - Sample:
    - 145 respondents, 10 in-depth interviews
    - respondents included investors, lenders, intermediaries, regulators from NZ.
  - Some key points:
    - investors require more detailed financial statements
    - additional information users would like includes:
      - enhanced segment reporting, more detailed cash flow information and information on credit facilities, borrowings and loans
    - other improvements:
      - greater consistency in presentation/format.
‘Lab project report: operating and investing cash flows’

• Summary
  — Sample:
    – 5 preparer entities and 16 investors/investor groups (30 individuals).
  — Some key points:
    – start indirect method with operating profit
    – show capex separately for tangible vs intangible and maintenance vs growth
    – use descriptions so that relationship to related items on other primary financial statements can be understood
    – provide related cash amounts for any profit or loss items designated as unusual, exceptional, etc.
‘Work plan for the consideration of incorporating IFRS into the financial reporting system for US issuers: An Analysis of IFRS in Practice’ (SEC Staff Paper, Division of Corporation Finance, Office of the Chief Accountant)

- Summary
  - Sample:
    - 183 companies in 22 IFRS countries (47 companies were SEC registrants).
  - Some key points:
    - *statement(s) of financial performance*—subtotals varied greatly (18 different subtotals were observed) and clear picture of how derived was often not available anywhere in the PFS or notes; some non-GAAP were presented on the face
    - *statement of cash flows*—significant differences among entities, and 10 variations in the starting point for the indirect method of operating cash flows
US SEC (2011), continued

• Summary, continued
  — Some key points, continued:
    – **statement of financial position**—’fair degree’ of comparability, but some variety linked to predecessor local GAAP.
    – **EPS**—alternative EPS included operating profit per share; normalized earnings per share; earnings per share before exceptional items; and earnings per share before restructuring, disposals, and other one-off items
    – variation in presentation due to both entity interpretation of IAS 1 and local country regulations.