DLSU
BUSINESS
NOTES AND BRIEFINGS
ISSN (Print): 2345-8216 | ISSN (Online): 2350-6814
Volume 5 | Number 5 August 2017

Ramon V. del Rosario College of Business

CBRD

Center for Business Research & Development

Can you really understand financial statements?

Written by:

Mr. Alloysius Joshua Paril
Assistant Professor
Accountancy Department
De La Salle University, Manila

Financial statements are an interesting species, if I may say. In those several pages, an entire picture of an entity is painted, at least in the financial aspect. As almost everyone knows, financial statements give us an idea of a company's performance during a particular period and condition as of a specific date. These documents are able to summarize everything that happened to a company during a 12-month period—probably more efficient than any document could.

Needless to say, these documents enable its users to decide on what to do with respect to that company. Investors take a look at financial statements to evaluate if the money they put in that company is still worth keeping. Creditors use financial statements to confirm if they could extend their credit to that company. The government mainly decides on the amount of tax that the company owes it. Employees—current and prospective—may want to look at it to see if the company is still stable and would be able to support them.

However, these are all textbook answers. It is not that they are incorrect; it is just that they might not actually reflect the reality. These are what financial statements should do, but do they really serve their purpose? To be more specific, do the people actually understand the content of these documents, such that it enables them to pursue their goal with respect to a particular company through the use of their financial statements?

This paper explores a particular aspect that any financial statement should have: understandability. The Conceptual Framework of the International Financial Reporting Standards lists understandability as one of the enhancing qualitative characteristics of useful financial information. To a lot of financial statement users, this is where it should all start. If these people can really understand the content of the financial statements, then they would be able to discern if such pieces of information would be useful for them or not, confirm if such information is what it purports to be, and even use them to compare with the same information provided by other companies. Do these people really understand what these financial statements say, or are these documents only reserved for the understanding of a selected few?

The IFRS

The preparation of the financial statements here in the Philippines is guided by the International Financial Reporting Standards (IFRS). Other companies use other frameworks for financial reporting; the other major framework being used is actually the US Generally Accepted Accounting Principles (US GAAP). The Philippines used to adhere to the US GAAP until 2005, when it immediately adopted the IFRS. Currently, there are 45 financial reporting standards that lay the guidelines in preparing these documents. These are just the IFRSs and the IASs (International Accounting Standards); they do not include the interpretations yet. The standard setters keep on adding to them every so often.

These standards help the creators of financial statement in determining the proper way to present the information. The guidelines set out make sure that the same principle is being applied by companies across industries, so that users won't have to shift their thinking or understanding when they encounter another set of financial statements.

However, that is the problem. Since the financial reporting standards keep on evolving, preparers and users both have to keep up, and normally it's the latter who is being left behind. The financial statement preparers would normally have no problems in updating their knowledge when updates are being released, because it affects their profession. However, such updates would probably affect the users adversely because they are rarely being informed about these improvements and changes. They are normally stuck with whatever they have from the start, so it would be no surprise if they wouldn't be able to understand most of the information anymore.

Since the updates and improvements are left to the understanding of the accountants, the users will tend to commit mistakes in their evaluation of the company. Landsman et al. (2011) showed that investors may not really understand the concept of "other comprehensive income." Their study mentioned that investors do tend to overvalue the firms that show negative other comprehensive income accounts. This particular finding somewhat already rings an alarm to the standard setters. The Conceptual Framework of the IFRS says that understandability can be assumed provided that a user has enough background and education. But it's not the reality.

Many people who have a business background do not really understand the concept of other comprehensive income (basically, these are items of income and expense that are not recognized in profit or loss, according to IAS 1). A handful of these people even have invested their money in companies reporting such items.

Readability

To put it bluntly, financial statements are replete with terms that are not understood by common individuals, and even some accountants for that matter. Terms like Unrealized Gain or Loss on Financial Assets at Fair Value through Other Comprehensive Income, Foreign Currency Translation Adjustment, and Liability under Share Appreciation Rights Plan are normally not understood, even by a person with a business background. Almost all financial statements have at least one item such as the ones I mentioned.

The readability of financial reports is critical to the effective communication of financial information to users so they can make economic decisions (Cheung & Lau, 2016). Financial statements are a communication tool, but if it loses its ability to communicate because it uses terms that are very hard to understand, then it loses its main purpose.

It is true that transaction nowadays have become more complex. If left understood, it would be easier for perpetrators to conceal their illicit activities even in the financial statements. Take for example the case of the Lehman Brothers who have contributed significantly to the great financial crash back in 2007/2008. It would have probably been mitigated if the financial statements have been clear on such things. Back then, their transactions were classified as 'off-balance sheet' accounts; meaning, they're not recorded in the face of the financial statements. This is one of the cases where financial reporting has failed the entire business community. Effective financial reporting does not have to focus on value creation, but on value realization (Nielse & Roslender, 2015). If it fails to do so, then matters such as these could arise.

Min & Joon (2016) argue that IFRS-based financial statements are harder to read than financial statements prepared using the local GAAP. The IFRS impairs financial statement readability. It is a hard claim, but one that standard setters and financial statement preparers cannot simply ignore. If this is the case, then no matter how much information is written on these documents, the best they could do is nothing. At worst, they can mislead the financial statement user.

Length

A complete financial report is seldom short. Normally, it's comprised of around a hundred pages. A typical person would not have picked and read such extensive report, unless he needs to. Definitely, the main focus of most users is the face: statement of comprehensive income, financial position, cash flows and changes in shareholders' equity. There are, however, so many pieces of information that are not explained by these such that notes are added. These notes are the ones extending such reports.

The notes to the financial statements help us understand more the figures presented in the face of the financial statements. Without them, we would not understand what those figures mean and how companies came up with them. They make the financial statements long and a bit intimidating to read. Instead of helping, they might even hinder current and potential investors and other users alike in understanding this company that piqued their interest.

It becomes counterproductive to the users when the volume of information provided by companies goes beyond a certain limit. (Ormin & Musa, 2016). Many details might not be helpful at all. That would eventually impair their decision-making ability, because the financial statements presented too many information for them to handle.

One may argue that it is the general purpose of financial statements that we are talking about. These reports are used by almost all external users; there are a few alternatives other than these for them to use in evaluating the company. Given that, they tend to be extended, because all the information that could be used by any of these users should be there.

Complexity

This is where things become a bit tricky, to say the least. Financial statements are a complex product of a complex financial structure. Financial statement preparers just follow and present the transactions and their effects on the financial statements as they happen. If such transactions are convoluted, its representation in the reports would more or less be complex as well.

And that is the thing with the field of financial reporting: It is reactive, not proactive. Financial statement preparers would just normally wait for a transaction to occur before they start working. That is just the way it is. The issue arising from this is that the field is not as aptly able to keep up with the changes and increasing complexities of financial transaction nowadays. This is what others capitalize on to earn easy profits.

Take for example what happened to Enron back in the early 2000s. Andre Fastow received an award and served time in prison because of the same thing: accounting loopholes. People used to applaud his so-called resourcefulness, but little did they know that they were already being fooled. Financial statement preparers and other financial reporting experts did not see this coming, because what Enron did have not yet been explained or even covered in any financial reporting standards.

Back in 2008, there is also the fall of the Lehman Brothers and the crash of the world economy. This all happened because they also found a loophole in dealing with derivatives. When we thought that things are already in place, this happens. Just like Enron, it was not seen by financial statement preparers and experts alike. The good news is that after this incident, financial reporting standards were already updated to cover such transactions. However, who knows what loophole will be found next.

Conclusion

We say that accounting is the language of business. Looking at financial reports now, maybe accounting is speaking a language that is not easily understandable. On the other hand, probably it is speaking an alien language. No matter what the case is, the field is not able to reach its objective.

Financial statements are a hard thing to understand, more so to digest. They are a product of one year's worth of transactions all summarized into a 100-page report. It is a bit difficult to summarize all these transactions and fit them into a single report. That is, however, not an excuse for these reports to be mystic or be intimidating to its users.

There have been initiatives in Australia to use plain language in financial reports (Cheung & Lau, 2016). This is one thing that we can also consider here in the Philippines. If accounting is the language of business, then it should be understood by almost everyone, or at least those who have a business background. That will not be achieved if financial statements keep on presenting and speaking terminologies that only accountants can understand.

Financial statement preparers and even the SEC and other government and private entities might also need to convene and agree on addressing this issue of lengthy financial statements issued by companies. Maybe they could do something about the way the information is presented, without losing any information that should be presented. With the use of technology, companies can consider making financial statements a bit more interactive, not just merely accessible in their websites. Such interactivity can aid investors in acquiring disaggregated financial statements, and even enjoy the benefits of improved judgement processes and outcomes (Kelton & Murthy, 2016).

People in the field of financial reporting have an obligation to the public: to lessen information asymmetry. No matter how many pieces of information is presented, if they are written in an obscure language or are presented in an unappetizing manner, such will not be achieved.

Sources

Cheung, E., & Lau, J. (2016). Readability of Notes to the Financial Statements and the Adoption of IFRS. Australian Accounting Review, 77(26), 162-176.

Kelton, A., & Murthy, U. (2016). The Effects of Information Disaggregation and Financial Statement Interactivity on Judgments and Decisions of Nonprofessional Investors. Journal of Information Systems, 30(3), 99-118.

Landsman, W., Miller, B., Peasnell, K., & Yeh, S. (2011). Do Investors Understand Really Dirty Surplus? The Accounting Review, 86(1), 237-258.

Min, H., & Joon, H. (2016). IFRS Adoption and Financial Statement Readability: Korean Evidence. Asia-Pacific Journal of Accounting and Economics, 23(1), 22-42.

Nielse, C., & Roslender, R. (2015). Enhancing Financial Reporting: The Contribution of Business Models. The British Accounting Review, 47, 262-274.

Ormin, K., & Musa, J. (2016). International Financial Reporting Standards and Financial Reporting Information Overload: Evidence from Nigerian Banks. 6th Annual International Conference on Accounting and Finance (pp. 9-17). GSTF 2016.

DLSU ISSN (Print): 2345-8216 | ISSN (Online): 2350-6814

BUSINESS

NOTES AND BRIEFINGS

Published by the De La Salle University Ramon V. del Rosario - College of Business, Center for Business Research and Development (CBRD)

Volume 5 No. 5 August 2017