The Benefits of Advanced Financial Reporting—Decision Usefulness and Speculative Evidence

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Introduction

The optimisation of financial market communication has become a recurring topic in the literature (Hillmer, 2012). Internationally, various standard setters such as the International Accounting Standards Board (IASB) or the U.S. Securities and Exchange Commission (SEC), as well as the European Securities and Markets Authority (ESMA) are dealing with this problem (Zülch and Weuster, 2017). Terms such as ‘information overload’ and the so-called ‘disclosure problem’ are especially relevant in this discussion, in which Paredes expressed his concern that financial reports are no longer understandable because they have become so full of information (Paredes, 2003). The doubts expressed by SEC chairwoman Mary Jo White about an ‘information overload’ of investors (Lynch, 2013) as well as the survey results provided by the IASB support this thesis. Over 80 percent of the survey participants acknowledge that the way financial information is currently presented could be enhanced, and instead of letting users to search through large amounts of data, the communication of relevant information within the financial statements should be improved (IASB, 2013). Furthermore, the ‘disclosure problem’ does not only encompass the abundance of information in corporate reporting, but rather aims at the relevance of the published data. As various studies show, a mere reduction in the scope of annual reporting is not enough for the users of financial statements: Shortening the length of annual reports increases clarity but does not enhance the crucial decision usefulness for the addressees (Zülch and Weuster, 2017). The IASB Chairman’s initiative to prioritise the communication effectiveness and improve the quality and usefulness of financial disclosures reflects this problem (IASB, 2016).

Given this prevailing lack of relevant information, looking at France can make a real difference.

In a unique regulatory environment and with the goal to provide enhanced information about a company’s business and financial situation, the financial markets’ authority advises firms to disclose advanced information that by far exceed the requirements of governing accounting standards, in this case International Financial Reporting Standards (IFRS). In other words, in order to improve the information content of their financial market communications, (French) companies can proactively consider voluntary reporting that goes beyond legal standards. This creates transparency about more relevant information and can thus significantly increase the decision usefulness for the addressees of financial statements. French companies impressively demonstrate what such voluntary external communication for e.g., financial risks can look like and what benefits it brings.¹

Voluntary, Alternative Reporting

With respect to risk management reporting, IFRS 7.33 and 7.34 require accounting entities to provide a qualitative and quantitative description of the nature and extent of financial risks arising from financial instruments. For the qualitative description (7.33), this includes both the extent and the origin of the risk exposures, as well as the “management's objectives, policies, and processes for managing those risks”. In quantitative terms (7.34), "summary quantitative data about exposure to each risk at the reporting date" must be disclosed. This information should be “based on information provided internally to the entity's key management personnel”. In the further course of this article, the focus is particularly on the relevance of the published quantitative data.

¹ With regard to risks, it is obviously important to distinguish between intentional and unintentional risks. Generally, companies take risks to achieve excess returns above the risk-free interest rate. These can be divided into two groups: risks that are part of the company's core business and other risks. While the risks belonging to the core business of the company lead precisely to the achievement of excess returns, the other risks occurring in everyday business do not have a fundamental positive influence on the business result and should therefore be reduced (at reasonable cost). For this reason, while some risks are taken deliberately, other risks are undesirable and companies try to reduce them, e.g., by using derivative financial instruments. This should be considered by investors, auditors or forensic accountants, who should assess the risks on a company and industry basis.

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Figure 1 shows the exemplary risk management reporting of an S&P 500 company on currency risk. (Figure 3 in the Appendix illustrates an example from a German DAX company with similar data granularity). This part of the annual report includes the fair value of all currency forward transactions (as evaluation parameter for the balance sheet), as well as sometimes their total nominal volume (long and short together) together with their residual maturity. A sensitivity analysis also shows the hypothetical effects of exchange rate fluctuations on the income statement.

**Figure 1: Exemplary Risk Management Report of an S&P 500 Company for the Currency Risk**

We hold currency swaps to hedge the currency exchange component of our net investments and also to hedge the currency exchange rate fluctuation exposure associated with the forecasted payments of principal and interest of non-U.S. denominated debt. The aggregate fair value of these swaps was in an asset position of $413 million at January 31, 2018 and a liability position of $147 million at January 31, 2017. The change in the fair value of these swaps was due to fluctuations in currency exchange rates, primarily the strengthening of other currencies relative to the U.S. dollar in fiscal 2018. A hypothetical 10% increase or decrease in the currency exchange rates underlying these swaps from the market rate at January 31, 2018 would have resulted in a loss or gain in the value of the swaps of $560 million. A hypothetical 10% change in interest rates underlying these swaps from the market rates in effect at January 31, 2018 would have resulted in a loss or gain in the value of the swaps of $22 million.


The company does not disclose the actual extent of the currency risks to which it is exposed at the end of the reporting period. It merely provides the total fair value of the swap contracts, any changes in that value and a hypothetical sensitivity analysis. Similarly, the German company (Figure 3, see Appendix) only indicates that forward transactions with a total nominal volume of 1,860 million euros have been concluded, but this is a composite total of purchase and sales contracts, i.e., opposing long and short positions. The underlying risk managed with these forward transactions is not communicated, nor are the currencies concerned. An evaluation of the hedging measures taken is not possible based on this data.

French companies show what voluntary reporting with more relevant information can look like. In a unique regulatory environment, the Autorité des Marchés Financiers (AMF), supervisor of the French financial markets, has established a so-called ‘registration document’. As optional supplement, it is intended to provide additional information about the company’s business, financial position, earnings and prospects for various stakeholders. For example, for financial risks such as foreign exchange (FX) risk, the AMF supplies in position paper n 2009–16 detailed guidance on corporate disclosures about the management of these risks. These guidelines are voluntary and by far exceed the requirements of IFRS 7.33 and 7.34 (Autorité des Marchés Financiers, 2009), as they advise companies to state their actual exposure before and after management by year and currency at the reporting date. Table 1 shows the recommendations of the AMF, including an exemplary numerical currency position.²

<table>
<thead>
<tr>
<th>Year</th>
<th>Assets [a]</th>
<th>Liabilities [b]</th>
<th>Forecasted [c]</th>
<th>Exposure Before Hedging [d] = [a] - [b] + [c]</th>
<th>Hedging Instruments [e]</th>
<th>Exposure After Hedging [f] = [d] + [e]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency 1</td>
<td>120</td>
<td>30</td>
<td>10</td>
<td>100</td>
<td>-50</td>
<td>50</td>
</tr>
<tr>
<td>Currency 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency n</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>


As Table 1 illustrates, the AMF specifically recommends that companies disclose their actual FX exposure before and after hedging per year and currency at the balance sheet date, as well as the composition of the risk from assets, liabilities

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² The original document is in French language and not available in English.
and forecasted transactions. In general, companies typically disclose their FX risk broken down by assets (column [a] in Table 1), liabilities (column [b]) and forecasted positions (column [c]). In total, this results in the net position of the FX exposure before hedging (column [d]). In addition, the companies provide information on the extent of hedging instruments used (column [e]) and the resulting net position after hedging (column [f]).

This information is given for each year and currency on the balance sheet date, with the numerical example in Table 1 illustrating the level of detail once again. For example, a company reports 120 units of FX receivables and 30 units of FX liabilities in a certain currency. The net value of 90 units is supplemented by forecasted transactions of +10 units. In total, the company has an exposure before hedging of 100 units (120 - 30 + 10) in this currency. This positive (long) exposure is now exemplarily hedged with -50 units (short), so that the exposure after hedging equals 50 units. Figure 2 shows an example of an actually published FX risk management report from France.

**Figure 2: Exemplary Presentation of a Published FX Risk Management Report of a French Company**

<table>
<thead>
<tr>
<th>Currency risk</th>
<th>31 December 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>(In million euros)</td>
<td>KRW</td>
</tr>
<tr>
<td>------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Total assets</td>
<td>394</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>(186)</td>
</tr>
<tr>
<td>Future transactions</td>
<td>(403)</td>
</tr>
<tr>
<td>NET POSITION BEFORE HEDGING</td>
<td>(195)</td>
</tr>
<tr>
<td>Derivative financial instruments</td>
<td>403</td>
</tr>
<tr>
<td>NET POSITION AFTER HEDGING</td>
<td>208</td>
</tr>
</tbody>
</table>

Source: PSA (Peugeot) Group, Registration Document 2018.

The comparison with US or German reporting shows the significantly higher information content and level of detail of the French reports. The quantitative indication of the risk before and after hedging per currency provides the reader with a clear picture of the origin and extent of the risks to which a company is exposed at the end of the reporting period. It further illustrates what specific hedging measures have been taken, i.e., to what extent the risk has been reduced or increased with derivative instruments.

**Assessment of Alternative Reporting**

The optional reporting proposed by the French Financial Markets Authority aims at providing “financial analysts, institutional investors and individual shareholders with the information that they need to make informed judgements about the company’s business, financial position, earnings and prospects.” The success of this is demonstrated by anecdotal evidence from interviews with treasury executives, among other things. In order to obtain professional and practical judgement, we interviewed four treasury executives of major German companies, including two DAX 30 companies. First of all, the results indicate that German companies internally use such control variables as the exposure before and after hedging but do not communicate them publicly. Furthermore, the treasury executives are of the opinion that such a data granularity benefits various stakeholders from financial analysts to shareholders and potential investors through more meaningful analyses. Above all, the surveyed practitioners also see a benefit for themselves: such an information base would enable companies to conduct unprecedented competitor analyses and thereby benchmark and improve their own risk management.

Furthermore, various studies show that these risk management disclosures, which go beyond the applicable reporting standards, bring further benefits for these stakeholders. In terms of risk management, the use of derivative financial instruments is discussed frequently in the literature, where it appears that derivatives are used for risk-decreasing (hedging) and risk-increasing (i.e., speculative) purposes. The intended increase of risk to generate additional profits has often led to endangering corporate losses in the millions and billions (Poitras, 2002). Based on the usual standard disclosures from US or German annual reports, the reader learns little about the strategy and intentions of using derivative financial instruments, where the literature agrees that investors are unable to identify speculation by analysing publicly available data (Géczy, Minton, and Schrand, 2007). The data granularity of the French reports, on the contrary, makes it possible to examine corporate risk management activities in detail and creates transparency as to whether

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derivative financial instruments have been used for hedging or speculative motives. In detail, the granularity of the publicly available data enables the calculation of firm-, year- and currency-specific hedge ratios and the classification into risk-decreasing (hedging) and risk-increasing/-constant (speculative) positions. In other words, based on a form of investigative, forensic accounting, the advanced financial reporting allows examining financial records to uncover financial irregularities. Have the hedging activities been effective, i.e., has the risk for the company and ultimately for the shareholders been reduced? Or has the company been exposed to a higher risk through (managerial, illegal or fraudulent) speculation? These questions can be answered using French risk management reporting, which for the first time allows speculative activities to be identified based on publicly available data. This increased transparency also raises the inhibition threshold for speculation and could thus prevent imperilling corporate losses from derivative transactions. Overall, such proactive financial communication, which goes beyond the legal requirements, creates trust and credibility among shareholders and various stakeholders.

As of today, the reporting requested by the AMF is voluntary. Despite the additional cost of compliance, the 'registration document' with the detailed risk management information is becoming the standard for French companies: According to the AMF, by mid-2013 more than half of the companies listed on Euronext Paris have already followed its guidelines.

Conclusion

In order to improve corporate financial communication, it is worth taking a look at France, a unique regulatory environment. Through detailed, voluntary guidelines that clearly exceed the requirements of IFRS 7.33 and 7.34, the French Financial Markets Authority is committed to providing more relevant information to the various addressees of corporate reporting. The results underline the importance of such advanced reporting with optional disclosures, which, as interviewed treasury executives also indicate, brings multiple benefits to shareholders and stakeholders.

Overall, the reporting from France increases the decision usefulness for the addressees of financial statements and thus provides the financial supervisory authorities and the standard setters of financial reporting with valuable information on what appropriate regulation can look like. In addition, through a form of forensic accounting, it is possible to uncover corporate speculation in the field of financial risk management, which can help to prevent fraudulent financial activities and imperilling corporate losses.
Appendix

Figure 3: Exemplary Risk Management Report of a German DAX Company for the Currency Risk

**CURRENCY RISK**

The fair value of the currency forwards at the balance sheet date was €3 million (previous year: €0 million), and their notional value was €1,860 million (previous year: €1,741 million). As in the previous year, all of the forward contracts have a remaining maturity of up to one year. The notional values represent the aggregate of all purchase and selling amounts for derivatives. The notional values shown are not netted.

If the euro had appreciated by 10% against all currencies as of December 31, 2018, the fair values of the currency forwards recognized directly within the hedging reserves in equity would have increased by €49 million (previous year: €55 million). If the euro had depreciated by 10%, the fair values of the currency forwards recognized directly within the hedging reserves in equity would have decreased by €65 million (previous year: €68 million). An appreciation or depreciation of the euro would not have a material impact on the consolidated financial statements when valuing currency forwards recognized in profit and loss. This is because the resulting changes in the hedged items would compensate for the effects of any changes in the market values.

References


