Problems with Using the Information from the Cash Flow Statement by Lenders (Banks) as Capital Providers

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Abstract

The number of quantitative and empirical studies on how, why and to what extent creditor banks (lenders) as providers of capital for enterprises, use the information from the financial statements of borrowers, including the information from the statements of cash flows (CFS). Such studies are mainly done by researchers from smaller economies or from developing countries (outside Europe) such as Vietnam, India, Jordan, Ghana, Nigeria, Bangladesh, Indonesia, Iraq, etc. The authors of the present study believe that Central and Eastern Europe, incl. Bulgaria, would be of research interest and the results of research on the relevant issue could be useful for a wide range of specialists and bodies, incl. and for the IAS Board (IASB). There is a need for research on the usefulness and quality of information presented and disclosed in financial statements based on IAS/IFRS prepared by enterprises in Central and Eastern Europe. Defining the problems associated with using cash flow statement information is the main subject of discussion in this research.

Keywords: IAS 7, cashflow statements, bank's analysis of cashflow information, cashflow ratios, cashflow analysis

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Introduction

Company cash flows and their management, incl. the use of the information related to them by lenders - banks are issues directly related to the economy of each enterprise. A significant component in the credit policy of each bank is the assessment of the creditworthiness of the borrowers. In this regard, a useful source of information is the reported and estimated cash flows of enterprises. The banks' reasonable credit policy guarantees stability, sustainability and development of the economy. Therefore, understanding, analyzing and managing a company's cash flows is a fundamental economic tool – both within the individual enterprise and from a global perspective of banking institutions. For their part, enterprises and financial and credit institutions are a building block of the economy of any country.

There is a direct link between crisis management in the enterprise (and in the economy) and cash flows from the point of view of the lending banks. Here are some of the arguments that explain this relationship:

1. Creditworthiness and risk management: The company's cash flows are a key factor in assessing its creditworthiness by banks. Banks use the cash flow information presented in a company's statements to determine whether it is able to repay its loans on time. Crisis management and maintaining sustainable cash flows increase the creditworthiness of the enterprise and reduce the risk for lenders. This, in turn, guarantees the stability of the financial system - on a national and international scale.

2. Sustainability and liquidity: Crisis management involves taking measures to maintain the financial sustainability and liquidity of the enterprise during a crisis. This is essential for lending banks, as ensuring stable cash flows allows the enterprise to repay its loans on time. Banks are interested in working with financially sound businesses that can keep their cash flows stable and meet their obligations.

3. Mutual trust and cooperation: Crisis management and effective cash flow management create mutual trust between the enterprise and the lending banks. When a business demonstrates its ability to manage crises and maintain sustainable cash flows, it puts itself in a better position to negotiate with banks regarding loan terms and the possibility of financial support.

4. Shared risk: Adequate presentation of information in the Statement of Cash Flows; the ability to manage crises and ensure stable cash flows can reduce the risk for banks as lenders, and hence - for the entire financial and credit system. If the enterprise is able to maintain stable cash flows and effectively manage emerging risks and crises, the probability of insolvency or failure to fulfill obligations to banks is reduced. This creates a lower risk for banks and motivates them to provide financial support and work in partnership with the enterprise.

5. Forecasting: Managing cash flows in crisis situations requires foresight and forecasting of potential risks and possible consequences. Cash flows provide information and data that support the process of forecasting and planning for upcoming financial needs during a crisis. This allows both the enterprise and its lenders to take preventive measures and develop strategies to manage their resources.

Therefore, the management of crises and risks in the enterprise and the management of the company's cash flows are essential for the relations with the banks - lenders. Stable cash flows and the enterprise's proven ability to manage crises create mutual trust, improve creditworthiness and reduce risk for lenders and also for the financial and credit system as a whole.

There is also a close relationship between the management of company cash flows, the banking approach and analysis in this regard, and the sustainable development of the participants in these processes: the enterprises and creditor banks. Increasingly, the good and sustainable management of companies requires them to allocate funds for environmental, social and management activities that add value and benefit not only to themselves, but also to the region, district, state and society in the broadest sense. of this word. Sustainable development, of which the drive for a green economy is a part, is about significant innovation, new technologies and well-prepared, skilled people. And all this requires a significant financial (monetary) resource. The role of creditor banks in providing financing aimed at activities guaranteeing sustainable development is extremely essential. This applies with particular importance to countries like Bulgaria (as well as to a number of other European countries), where traditionally, historically, the leading source of financing for enterprises is bank credit, and to a much lesser extent - the capital market.

1. Defining the research question.

Financial statements based on IAS/IFRS **are general purpose statements, i.e. are addressed to a wide range of users**. However, the scientific literature is dominated by studies related to the relationship between IAS/IFRS and the information needs of the investors. This is in some contradiction with the **IFRS concept of general purpose statements and requires additional research** addressed to the information needs and problems of the other users of the information from these reports. According to the Revised IAS/IFRS Conceptual Framework (2018), capital providers cover **two categories of entities: investors (current and potential) and creditors (including banks)**. Much more limited is the number of quantitative and empirical studies on **how, why and to what extent banks (lenders) as providers of capital for enterprises use the information from the financial statements of borrowers, incl. the information from the Cash flow statement (CFS)**. Such research has mainly been conducted by researchers from smaller economies or from developing countries (outside Europe) such as Vietnam, India, Jordan, Ghana, Nigeria, Bangladesh, Indonesia, Iraq, etc. (Nguyen, D. D., Anh Huu Nguyen (2020); Maheshwari, A. (2018); Mohammad Fawzi Shubita (2021); Riana, W. (2021); Amuzu, M. S. (2010); Singh, S. (2021); Al-Shaikh, S. S. K., Al-Refiay, H. A. N., & Abdulhussein, A. S. (2023), etc.). We believe that Central and Eastern Europe, incl. Bulgaria, would be of research interest and the results of research on the relevant issues would be useful for the standard setters and for the users of financial information.

The EU is the largest regional community that has introduced the mandatory application of IAS/IFRS in relation to the consolidated financial statements of public (listed) companies. The data indicate[1] that each EU member state has the right to expand the range of enterprises that must apply IAS/IFRS, incl. to allow voluntary application of IAS/IFRS. This is also the case with Bulgaria. According to Art. 34 (2) of the Bulgarian Accounting Law, all financial and credit institutions; all listed companies and large enterprises of public interest (PIE) should apply IAS/IFRS[2]. These are approximately between 600 and 800 companies (Accountancy Europe, 2017) and for the EU their number is about 7,000 - 10,000. Therefore, the number of Bulgarian companies applying IAS/IFRS is about 6-8% of the total number for the EU, which is a significant figure in within 27 member states. The significance of these enterprises - financial and non-financial - predetermines the importance of the accounting basis applied by them - IAS/IFRS. Therefore, there is also a need for studies on the usefulness and quality of the information presented and disclosed in the financial statements based on IAS/IFRS prepared by enterprises in Central and Eastern Europe.

The data on the scale of bank lending in the EU, including in Bulgaria, show its significant size and role in the development of the European economy, which means that **banks are the main element of corporate financing in Europe**. In addition to lending, they offer their clients a wide range of modern financial services, especially in the field of payments, export financing, risk management or access to capital markets. As noted by the European Banking Federation, European banks help entrepreneurs, family businesses and local and multinational companies to access financing instruments of different types, adapted to their needs as according to their data in the conditions of difficulties, loans to non-financial companies continue to show a positive trend. (European Banking Federation, 2022). **Debt financing is particularly important for businesses in the EU**. According to Statista, the value of bank loans represents about 70% of the GDP of the member states. (Statista, 2022) According to the same source, loans and advances represent over 60.6% of bank assets in the EU in 2021, with mortgages and business loans being the segments with the highest market share.

The decomposed data by countries in Statista.com clearly outlines the trend that loans to non-financial enterprises (business loans) and mortgage loans are the predominant part of banks' assets in the form of loans. The share of types of loans is different in different countries, as even in Denmark (the country with the smallest share of loans to non-financial enterprises), the share of business loans is 33%. Business loans have a similar share in Germany - 36%, Sweden - 36%,

[1] EU Regulation 1606/2002, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32002R1606

[2] Banks in Bulgaria have been applying IAS since 2002, i.e. before their mandatory introduction into the EU, and before the entry of Bulgaria into the EU (2007). This period of more than 20 years is a good basis for accumulating experience in the application of IAS/IFRS, incl. and IAS 7. The situation with Bulgarian public (listed) companies is similar. They also started applying IAS from the end of 2002, resp. since the beginning of 2003.

Belgium - 39%, and in some countries this total is even over 50% of all loans granted, with **the highest share of business loans in Bulgaria - 62%**[3].

As of November 2022, according to ECB data, loans granted to non-financial enterprises increased by an average of 15.49% compared to 2019, reaching 5.175 EUR billions, with loans between 1 and 5 years increasing by between 10.1% and 14.3%. (ECB, 2022) It is interesting to trace how the structure of corporate financing has changed over the years. According to Raposo & Lehmann, the share of loans in corporate financing for the period 2008-2016 was between 30 and 45%, which makes this source essential for the business activity of the enterprises (Raposo & Lehmann, 2019).

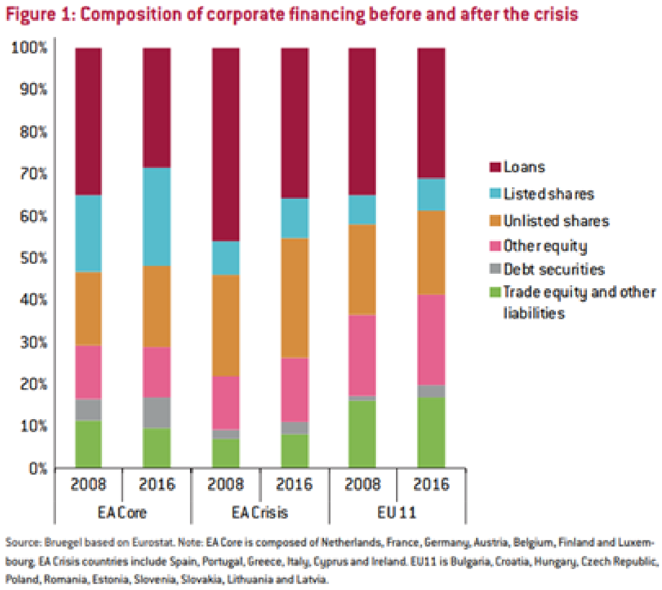

Figure 1. Composition of corporate financing for 2008 and 2016

Source: Raposo, I., Lehman, A. Equity finance and capital market integration in Europe, PC-2019-03.pdf (pitt.edu)

We also find support for the statement about the importance of loans as a form of business financing in the Eurostat data for 2021, according to which **the share of loans in the structure of the liabilities of Bulgarian non-financial enterprises is about 28%, while in some EU countries this share reaches 50 %**. (Eurostat, 2022)

[3] Composition of loans in the European Union in 2020, by country. Statista.com, https://www.statista.com/statistics/1301197/composition-of-loans-in-the-eu-by-country/ 20.02.2023.

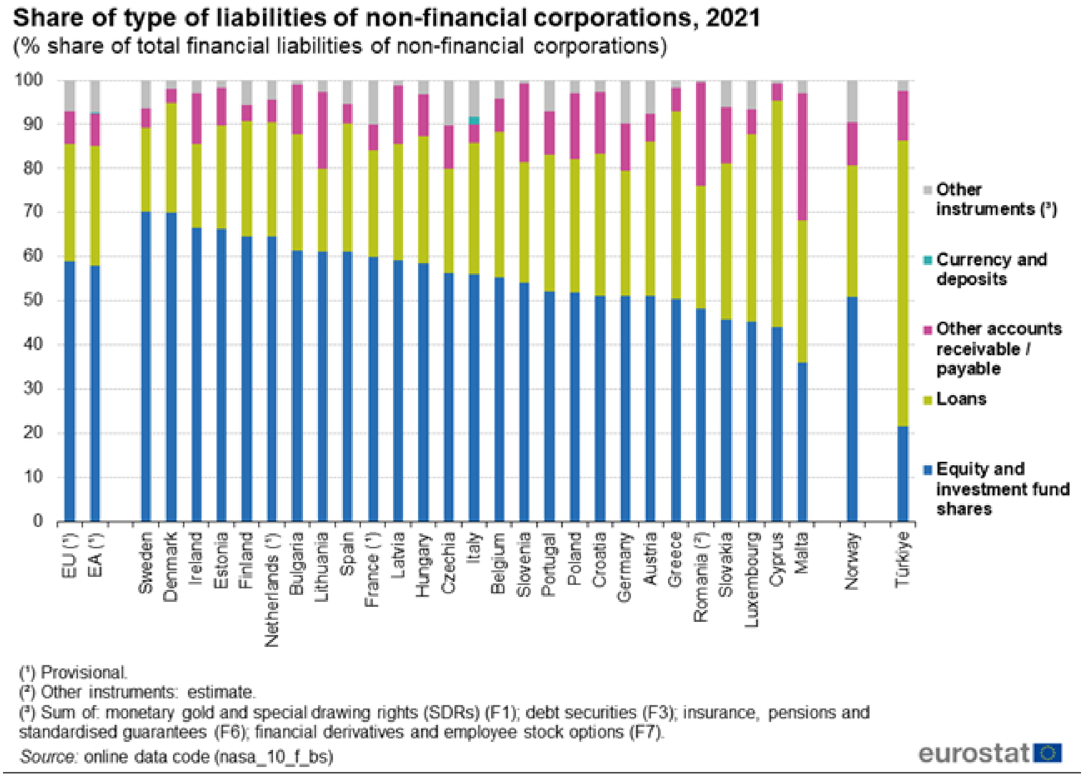

Figure 2. Share of type of liabilities of non-financial corporations, 2021

Source: Eurostat: Non-financial corporations - statistics on financial assets and liabilities - Statistics Explained (europa.eu)

According to data from the quarterly bulletin of the Bulgarian National Bank (BNB), as of June 30, 2022, **loans represent 61.1% of all bank assets**. For this period, according to BNB statistics, the gross credit portfolio of the banking system grew by 2.9% (BGN 2.3 billion), with loans to non-financial enterprises increasing by BGN 582 million, i.e. 1.4%. **Of all the loans provided, the largest share is the loans for non-financial enterprises, representing 47.5% of all loans provided by the banking system in Bulgaria**. (BNB, 2022).

Hristozov points out that in 2018 liabilities to financial institutions have a share of about 40% in the structure of liabilities of non-financial enterprises in Bulgaria (Hristozov, 2020). According to NSI data for 2021, the value of loans in the accounts of non-financial enterprises in Bulgaria is BGN 92,989 million, which is 41.55% of all liabilities. (NSI, 2022) The indicated data are proof of the importance of this source for financing the Bulgarian business in the last four years.

According to data from the Deutsche Bundesbank for two of the largest economies in the EU for the period 2008-2018 (Germany, France): in Germany, the structure of external financing of non-financial enterprises is slightly mixed in favor of financing through debt capital. The increased use of debt capital can be interpreted as a response to the improved solvency of non-financial enterprises in Germany in light of the favorable economic development, which allows for higher leverage on the one hand. On the other hand - the low cost of debt financing is also likely to have played a role. Regarding non-financial corporations in France, equity and debt capital inflows roughly balanced each other as of 2018. Therefore, the structure of financing remained unchanged. (Deutsche Bundesbank, 2018)

As a result of the summary of the reasons for choosing the scientific problem, **the following scientific question can be defined: To what extent and how do banks (as lenders) use information from borrowers' Cash Flow Statements? What part of the information do they find useful and what should be improved? To what extent do banks use information from**

borrowers' cash flow statements when assessing credit risk and creditworthiness, and when applying the expected credit loss model (according to IFRS 9)?

The answer to the above scientific question requires solving the following research tasks:

1. To establish the information needs of the capital providers - the banks, mostly related to the analysis and assessment of the way of managing the cash flows by the borrower companies. To define a system of indicators useful for banks (as creditors) and the possibility to calculate these indicators based on data from the Cash Flow Statement and related information. This should take into account the two types of lending: asset-based lending and cashflow-based lending.

2. To identify the most common omissions and errors in the classification, presentation and disclosure of information in the Statement of cash flows of enterprises, including borrowers and to make proposals for clearer and strict regulation of this issue in IAS 7.

3. To establish the participation/inclusion and significance of cash equivalents and cryptocurrencies in the Statement of Cash Flows and to assess to what extent this matter should find a more significant place in IAS 7.

4. To establish what information related to financial commitments agreed with suppliers and information on non-cash transactions is presented and disclosed in the Cash Flow Statements by the investigated enterprises, and what in this regard can be improved in IAS 7. To discuss whether it is appropriate at all to present and mix the two sources of financing – cash and non-cash – in one report (Cash Flow Statement).

5. To find out to what extent banks (as lenders) use certain information and what information they disclose related to the cash flows of borrower companies, when applying the expected credit loss model (IFRS 9).

The initial authors’ thesis is that with the current regulatory framework in Bulgaria, related to the statement of cash flows - NAS 7 and IAS 7, as well as based on the prevailing practice, the quality of preparation and information usefulness of this report are not at the required level. The following should be mentioned as the most significant problems related to its preparation:

- ✓ Lack of clear criteria in the two standards cited above regarding the classification of cash flows in the three groups: operational, investment and financial. What's more: Whether today this division is no longer outdated and to what extent it manages to show how the enterprise's business model is tied to and affects its cash flows?;
- ✓ Too general requirements (which often creates an opportunity for a subjective approach on the part of enterprises) when classifying cash flows within each of these three groups;
- ✓ Lack of regulated binding interrelationships between the statement of cash flows and other parts of annual financial statements;
- ✓ Lack of sufficiently comprehensive requirements related to the disclosure of information about the content of the report, and above all - the criteria for classifying cash flows, especially some more specific ones, which can alternatively be treated as one (e.g. the operational) as well as to another group (e.g. the financial).
- ✓ Strong neglect by the enterprises of the quality of preparation of this report; even some of them in Bulgaria are not obliged to compile it (see Art. 29, paras. 1 to 7 of the Bulgarian Accountancy Act).

2. References to relevant research and methods to be used to carry out the research.

A large part of the research devoted to the application of IAS/IFRS establishes that a number of specific national factors influence the way of application, the benefit and the effects of the application of this accounting basis. In this regard, we accept the thesis of Gi Chen and Katherine Schipper (Chen & Schipper, 2016) that “country-specific analysis have the potential to provide useful empirical evidence as to which specific aspect of IFRS has a specific posited effect, thereby shedding light on the causal channel through which IFRS adoptions affect capital market outcomes”. Moreover, in the cited article, the authors appeal for “more empirical studies that tie closer to recent advances in theoretical research that speak to these issues” (Chen and Schipper, 2016). We believe that both empirical and theoretical research related to the concept of corporate cash flow classification, disclosure and use for analysis and forecasting purposes (including by banks as lenders) is insufficient compared to studies devoted to the accrual principle and its application in preparing the statement of comprehensive income, the statement of financial position, the statement of changes in equity. Because of this, the Statement of Cash Flows (CFS) remains ‘in the shadow’ of the other three statements, which leads to a certain neglect of quality in its preparation by the compilers of financial statements, and even by some of the auditors. This is unjustified, unacceptable, considering that cash and cash flows are the ‘blood of the business’. Moreover, for a part of the users of financial information - the banks, the knowledge about the cash flows management by their customers is of crucial importance for the conditions under which they provide their banking products, including lending. The clarification of the theoretical foundations of the cash principle, its difference with the accrual principle, also requires a better definition of criteria for classifying the company's cash flows in the Cash Flow Statement. In this regard, we support the efforts of the IAS Board regarding the Primary Financial Statements project, including "entities to present more subtotals and more specific classifications of items" (Tarca, 2018). The discussion on the appropriateness of the two formats/approaches for preparing the Statement of Cash Flows (direct and indirect) (Kwok, 2002); (Hodge, Hopkins & Wood, 2006) also raises many questions from the point of view of the information needs of banks as lenders, which must be adequately answered. Moreover, the number of similar studies for countries from Central and Eastern Europe is missing or very limited. In this context, Professor Donna L. Street's views on conducting research in developing countries and countries in transition can also be mentioned (Street, 2016). Bulgaria and some of the countries in the annual Coface Top 500 CEE ranking would fall into this category.

We plan to use the following research methods:

- Empirical analysis of archival data, including content analysis of information in the public financial statements of the entities in the samples. The samples will consist of the following groups: all 25 banks in Bulgaria; the largest Bulgarian enterprises participating in the annual Coface Top 500 CEE Ranking, including other biggest CEE entities, depending on access to publicly available financial data and other relevant information;
- Online surveys addressed to: 25 banks in Bulgaria; the ‘Big four’ accounting firms (their offices in Bulgaria); the Bulgarian CPAs (more than 700 people) and auditing entities (over 80 in number), all members of Bulgarian Institute of Certified Public Accountants; Bulgarian National Bank, Department of Banking Supervision; Financial Supervision Commission (FSC), The Commission for Public Oversight of Statutory Auditors (CPOSA); sample of entities (CEE) applying IAS/IFRS.

Conclusion

The authors consider the expected benefits of this ongoing research for the interested parties, including IASB in connection with the planned improvement of IAS 7, in the following areas:

1. Improving the content and the structure of IAS 7 (and NAS 7) from the standpoint of the information needs of another important group of users (besides investors) – the banks (as creditors and capital providers).

2. Introduction of more and clearer criteria in IAS 7 (and NAS 7) for classifying cash flows in the three directions: cash flows from operating, investment and financial activities.

3. Introduction of additional disclosure requirements in IAS 7 (and NAS 7) through which the users of information can gain insight into:

✓ the classification of some more specific but essential cash flows related to the specifics of the activity and/or the business model of the enterprise;

✓ the relationship of the presented cash flows and information with the remaining 3 main reports (statement of financial position, statement of comprehensive income, statement of changes in equity), with the notes to the financial statement and with the management commentary;

✓ the relationship between the information in the Cash Flow Statement and calculated and disclosed indicators such as: free cash flow; liquidity; solvency; working capital ratios; non-cash financing, etc.;

✓ introduction of additional requirements in IFRS 9 regarding the disclosure of information by banks (as lenders) related to the use of data from the Statement of Cash Flows of borrowers when applying the expected credit loss model and credit risk assessment.

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