

## How credit analysts view and use the financial statements

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### Introduction

Traditionally it is viewed that equity investment is high risk and bond investment low risk. Bondholders look at companies for creditworthiness, whereas shareholders look for the ability to increase earnings per share. However, there are many types of bond and equity investors with differing requirements and criteria for investment. Whilst the requirements of equity analysts have been widely debated, the focus of this paper is credit analysts' requirements and what should be the new information content of the financial statements in their opinion, rather than focus on equity analysts.

To arrive at the recommendation of this paper; staff conducted a series of interviews with credit analysts and bond fund managers. The appendix to this paper considers some issues, such as what bond holders look for when investing.

### **New information content suggested by credit analysts and bond fund managers for the financial statements**

The following were noted by those interviewed as being of useful content for financial statements. Increased cash flow projection information – it was noted that whilst the financial statements contain comprehensive information on earnings; there is not sufficient forward looking information provided on cash flows; specifically contractually agreed short-term cash outflows such as:

- Near term maturities of financial debt and bank facilities as well as major non-negotiable cash outflows, e.g. to tax authorities or suppliers or on major investment projects;
- Derivative arrangements due for renewal and terms of put options written;
- Percentage of currency positions which have been hedged;
- Pension fund cash flows; and
- Hedging of risk (eg. critical commodities such as the price of jet fuel for airlines).

This information is especially useful for credit analysts who need to project cash flows to gauge the risk of borrowers' defaulting because of mandatory cash outflows exceeding available liquid resources and cash inflows.

Some credit analysts noted that the balance sheet often presents an incomplete summary of a company's assets and liabilities; for example, valuable assets such as an airline's landing slots at heavily congested airports are rarely recorded and the accounting for corporate pension obligations is often sensitive to undisclosed assumptions.

Credit analysts noted that more information on operating margins by country and product line would be useful. However they also noted that they understood that entities preferred not to give this information in the financial statements because they considered it to be commercially sensitive.

The structure of a group is also a potential source of risk if intra-group transfers of cash undermine the debt investor's claims and favour shareholders. For example they could be issuing bonds from a subsidiary and upstream cash to a group that pays dividends. There is also the risk of subordination: the company must satisfy shareholders and bondholders.

Furthermore, the practise of presenting netted information on cash flow and debt items was highlighted as a deficiency. Wherever possible, companies should break down the respective constituents of net figures in their cash flow and debt reconciliation statements. In addition, the absence of underlying information on net debt makes it difficult to analyse the impact of foreign exchange movements, the value of debt acquired or disposed through business combinations and the impact of fair value and fair value hedge adjustments.

### **What information is not useful in the financial statements?**

Some credit analysts noted that fair value information was on occasions not useful and in some cases could be misleading. A senior credit analyst said that;

'The process of fair valuing many financial assets often rely on models and estimates and is thus susceptible to management judgement, if not manipulation. Fair value accounting is based on the assumption of functioning asset markets which does not apply to the vast majority of financial securities, especially in environment which has been prevailing for many years now.

Fair value fluctuations have increased the level of 'noise' in financial accounts without adding much value, especially fair value gains and losses on assets would often neither be realisable nor relevant as the respective positions are either illiquid or held to maturity. Fair value movements on liabilities are even more obsolete from a credit analyst's perspective as they do not alter an entity's contractual obligations to its creditors and thus its risk of default. Overall fair value accounting seems to have made financial accounts more volatile and subject to random factors and/or management judgement. Credit analysts look at balance sheet values to evaluate an entity's net worth in a going concern scenario and its break-up value in a gone concern scenario. Fair value accounting does not appear useful under either of these objectives, given its above counterproductive effects and flaws, especially in an illiquid market environment.'

### **Recommendation**

The conclusions to this review are that the FRC should:

- a. seek to influence the IASB to spend more time talking to credit analysts as a separate class of users; and
- b. in developing UK financial reporting standards, the needs of debt financiers rather than solely equity financiers should be considered.

## Appendix 1

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### What do bond investors look for?

#### The determinants of Bond Prices

The differences that affect bond prices are, spot rate, yields to maturity, the expected return in the next period, and the risk associated with next period's return as measured by the spread over the risk free yield for the reference maturity. Standard bond theory deals with the determination of the yield to maturity or price. The yields to maturity on bonds differ for a number of reasons. Among the most important are the following.

- The length of time before the bond matures;
- The risks of not receiving coupon and principal payments;
- The status of the cash flows;
- The existence of provisions that allow the corporation or governments to redeem the debt before maturity;
- The amount of the coupon.

There are a number of theories behind how bond investors decide how to invest their monies:

#### Theories - Segmented Market Theory

Segmented market theory has its origin in the observation that many investors and issuers of debt seem to have a strong preference for debt of a certain maturity. Furthermore, they seem to be insensitive to differentials in yields between debt of this maturity and debt of a different maturity.

Consider first, debt with a long maturity. For example life insurance companies offer insurance policies that are unlikely to make any payment for a long time. An insurance policy issued to a 25 year-old individual may involve 15 or more years before the company anticipates having to make a payment. The size of the premium payments is determined in part by the anticipated interest rate. If the insurance company invests in a long-term bond, the interest earned on the bond is known and if it exceeds what was promised on the insurance contract, it substantially reduces the insurance company's risk. There is still some risk because the coupon payments will have to be reinvested at some future unknown rate. However, the principal remains invested at a known rate, which substantially reduces their risk.

Alternatively the insurance company could meet its long-term obligation by buying a sequence of one-year bonds. However, in this case, all earnings beyond the first year are unknown. If interest rates decline below what are anticipated in the insurance contract, the company may have difficulty meeting its obligations. Not only is there uncertainty associated with the rate that will be earned on the investment of the coupon payments, there is also uncertainty on the rate earned on the principal. Consequently many insurance companies invest in long-term bonds even when short-term rates are considerably higher than long-term rates.

Market segment theory argues that investors are sufficiently risk averse that they operate only in their desired maturity spectrum. No yield differential will induce

them to change maturities. Thus, what determines long-term rates is solely the supply and demand of long-term funds. Investors who believe in market segmentations theory examine flows of funds into these market segments in order to predict changes in the yield curve.

### **Pure Expectations Theory**

The pure expectations theory explains the term structure in terms of expected one-period spot rates. Advocates of the expectations theory believe that the yield on a two year bond is set so that the return of that two year bond is the same as the return on a one year bond plus the expected return on a one-year bond purchased one year hence. If this theory is correct, then an upward sloping yield curve is an indication that short-term rates are expected to increase. Similarly a flat yield curve is an indication that short-term rates are likely to remain the same. Finally, a downward sloping yield curve indicates that short-term rates are expected to decline. Under the pure expectations theory the yield curve can be derived directly from a series of expected one-period spot rates.

### **Liquidity Premium Theory**

Liquidity theory is also based on investors analysing the returns from holding bonds of varying maturities. However, unlike pure expectations theory, liquidity premium theory assumes investors must be offered a higher expected return to hold a bond with a horizon different from their preferred horizon. Furthermore, it is assumed that there is a shortage of longer term

investors so that extra return must be offered on long-term bonds to induce investors to hold them.

Liquidity premium theory modifies the previous conclusions drawn on the shape of the yield curve and the implied one-period rates in future periods. If expectations are for an unchanged one-period rate, then the presence of the liquidity premium imparts an upward sloping shape to the yield curve.

### **Preferred Habitat Theory**

Preferred habitat theory rests on the premise that investors who match the life of their assets with the life of their liabilities are in the lowest risk position. Matching the life of the assets and liabilities is their preferred position. If there is sufficient extra return to be earned on assets of other lives, they will adjust their position to include more of the higher yielding assets.

### **Default Risk**

Regardless of which of the above theories is more prevalent in determining how bond investors invest their monies there is one important factor which is increasingly becoming more important - Default risk

Investment in bonds is not without risk. Both government and corporate bonds have a risk of default – ie the coupon of principal payments will not be met. For these bonds it is necessary to make a distinction between the promised return and the expected return. In addition since there is a risk associated with these bonds, investors should require that the

expected return is greater than the return on a similar bond that is default free.

The traditional view is that the risk spectrum starts with cash (low risk) and moves on to government bonds, corporate bonds and equities. In addition, corporate bonds are risky and government bonds are risk-free. However recent events in Europe have challenged this view. Greece is on the verge of default and there are problems in sovereign credit markets, while investment-grade corporate credit is less risky than five years ago.

Corporate bond investors are interested in how they perceive a particular company's credit rating will improve vis-à-vis its current credit rating. They are interested in the company's attitude to improving its credit rating, whether or not they agree with the actual rating.

**How are the conversations with debt investors different from those of equity investors from a company's perspective?**

Strictly speaking there should be no difference since companies should give the same strategic message to debt and equity holders, rather than tailoring their message to either group's perceived expectations. In addition, the more indebted a company, the more important earnings per share can become for bondholders as well as shareholders. For example, a high-yield company is likely to have a business plan that commits it to growing its way out of debt.

There are nuances when it comes to bond value versus equity value. What may be

good for bondholders is bad for shareholders, and vice versa. For example, if a company enters into difficulties and has a rights issue; there is a larger cushion of risk capital which arguably provides an extra cushion for bondholders. But if a company buys back its own shares (share buyback), using cash on its balance sheet, there is a smaller cushion, which is arguably to the detriment of bond holders; but considered favourable to equity holders.

Another example of the different treatment of investors can be found in the banking sector. Some banks have given investors in their covered bonds a prior claim on a company's earnings, compared with senior unsecured bondholders.

**Pension Risk**

Investors need to be informed about all of a company's liabilities, which include not just bonds and loans but also any pension scheme deficit. Directors must pay cash to the trustees of defined benefit pension schemes that are in deficit. Share option schemes must be properly expensed and leasing by a retailer must be included. In addition companies should properly inform investors the ways in which they have insured against risk. For example if pension scheme trustees have sold equities and reinvested the proceeds in the most secure bonds, that exposes investors to lower risks than if the pension fund had invested heavily in equities. Other ways to reduce risk involve, selling pension liabilities to insurers and paying investment banks to bring in hedging strategies – although sometimes if they

are not assessed correctly they may have the opposite effect of increasing risk.

### **The conflict between shareholders and creditors**

There is an agency conflict between creditors and shareholders. Creditors have the primary claim on part of the firm's earnings in the form of interest and principal payments on the debt as well as a claim on the firm's assets in the event of bankruptcy. The shareholders maintain control of the operating decisions (through the firm's managers) that affect the firm's cash flows and their corresponding risks. Creditors lend capital to the firm at rates that are based on the riskiness of the firm's existing assets and on the firm's existing capital structure of debt and equity financing, as well as on expectations concerning changes in the riskiness of these two variables.

The shareholders, acting through management, have an incentive to induce the firm to take on new projects that have a greater risk than was anticipated by the firm's creditors. The increased risk will raise the required rate of return on the firm's debt, which in turn will cause the value of the outstanding bonds to fall. If the risky capital investment project is successful, all of the benefits will go to the firm's shareholders, because the bondholders' returns are fixed at the original low-risk rate. If the project fails, however, the bondholders are forced to share in the losses.

Managers can also increase the firm's level of debt, without altering its assets, in

an effort to leverage up shareholders' return on equity. If the old debt is not senior to the newly issued debt, its value will decrease, because a larger number of creditors will have claims against the firm's cash flows and assets. Both the riskier assets and the increased leveraged transactions have the effect of transferring wealth from the firm's bondholders to the shareholders.

Shareholder-creditor agency conflicts can result in situations in which a firm's total value declines but its share price rises. This occurs if the value of the firm's outstanding debt falls by more than the increase in the value of the firm's common stock. If shareholders attempt to expropriate wealth from the firm's creditors, bondholders will protect themselves by placing restrictive covenants on future debt agreements. Furthermore, if creditors believe that a firm's managers are trying to take advantage of them, they will either refuse to provide additional funds to the firm or will charge an above-market interest rate to compensate for the risk of possible expropriation of their claims. Thus, firms which deal with creditors in an inequitable manner either lose access to the debt markets or face high interest rates and restrictive covenants, both of which are detrimental to shareholders.

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