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Investor Perspectives

Providing insights into cash flow economics

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In May 2023 the International Accounting Standards Board (IASB) issued disclosure requirements[1] that enhance the transparency of supplier finance arrangements. These requirements complement requirements in IFRS Accounting Standards for companies to provide disclosures that enable users of financial statements to evaluate changes in debt. The IASB encourages companies to consider early application of the new requirements and to review the effectiveness of their own existing disclosure about changes in debt.

Investors need information about both cash flows and non-cash changes in debt to compare and evaluate companies. IASB member **Nick Anderson** explains the information companies reporting under IFRS Accounting Standards are required to disclose about non-cash changes in debt and how this supports investors in their analysis.

Executive Summary

Transactions that result in changes in a company's reported debt that are not reflected in the cash flow statement have become more common. Such transactions can relate to supplier finance, acquisitions and lease financing, for instance. Information about non-cash changes in debt can be found in the debt reconciliation that most companies provide[2]. Investors often use this information to adjust reported cash flows when analysing a company's financial statements or valuing its shares.

Is Cash still king?

Most investors will be familiar with the refrain 'cash is king'. Experienced analysts and portfolio managers would often advise those new to the profession to 'follow the cash and you will understand the business'. This advice was intended to convey the importance of understanding a company's cash flow dynamics. However, a significant challenge for investors is the increasing prevalence of non-cash changes in debt that are regarded as being economically equivalent to cash flows. Because these transactions do not involve cash flows, they are not reflected in the cash flow statement.

A note on terminology

IFRS Accounting Standards use the term *liabilities from financing activities*. Most investors would refer to such liabilities as debt and for the purpose of this article the term 'debt' is used as shorthand for these liabilities.

Non-cash changes in debt occur, for example, when a company changes the classification of liabilities related to supplier finance arrangements (including arrangements referred to as reverse factoring). The disclosure requirements the IASB issued in May 2023[3], enhance the transparency of supplier finance arrangements and their effects on a company's liabilities, cash flows and exposure to liquidity risk. These requirements come into effect for reporting periods beginning on or after 1 January 2024; more information can be found in our May Investor Perspectives article[4].

1 Amendments to IAS 7 *Statement of Cash Flows* and IFRS 7 *Financial Instruments: Disclosures.*

2 The main exception is companies in financial sectors such as banking and insurance.

3 IFRS Foundation - *IASB increases transparency of companies' supplier finance*.

4 Investor Perspectives (May 2023), Zach Gast, IASB Member.

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Non-cash changes in debt also occur when a company takes on acquired debt as part of an acquisition, when companies enter into leases, from foreign exchange changes or from changes in fair values, for instance. Below, we further explore two examples—supplier finance arrangements and acquisitions.

Supplier finance arrangements that involve balance sheet reclassifications

Under some supplier finance arrangements, trade payables retain their classification in a company's balance sheet after they are approved for inclusion in the arrangements. In other arrangements, there could be a change in classification—the trade payable could be derecognised and a new finance payable recognised. Feedback from investors suggested that knowing when a company changes the classification is essential in analysing both liabilities and cash flows. The change in classification could result in a change in reported cash flows: an operating cash inflow when the trade payable is initially created followed by a financing cash outflow when the new finance payable is paid. In this scenario investors have indicated that they view the reclassification as inflating operating cash flow and reverse its entire effect in their analysis of free cash flow.

Illustration of balance sheet reclassification

<table>
<tr><th>CU million</th><th>Trade payable created</th><th>Trade payable derecognised and finance payable recognised</th><th>Finance payable paid</th></tr>
<tr><td>Balance sheet</td><td></td><td></td><td></td></tr>
<tr><td>Trade payable</td><td>+100</td><td>-100</td><td></td></tr>
<tr><td>Finance payable</td><td></td><td>+100</td><td>-100</td></tr>
<tr><td>Cash flow statement</td><td></td><td></td><td></td></tr>
<tr><td>Operating cash flows</td><td>+100</td><td rowspan="2">No cash flow recorded</td><td></td></tr>
<tr><td>Financing cash flows</td><td></td><td>-100</td></tr>
</table>

Acquisitions that involve non-cash transactions

Let's use an example of a company (Company A) that acquires two companies (Companies B and C) that are identical apart from their financing structure.

Company A's acquisition of Company B:

- Company A acquires Company B for CU100 million. Company B has no cash or debt.
- The cost of the acquisition, which is shown as an investing cash outflow in Company A's cash flow statement, is CU100 million.

Company A's acquisition of Company C:

- Company A acquires Company C for CU60 million. Company C has CU40 million of debt.
- For the acquisition of Company C, the cost (investing cash outflow) shown in Company A's cash flow statement is CU60 million. However, the acquisition of Company C will result in Company A assuming a further CU40 million of debt. This will be reflected on Company A's balance sheet when it consolidates Company C.

From an economic perspective, Company A's acquisitions of Companies B and C are identical. However, this is only evident by analysing information about the changes in both cash and debt.

Illustration of non-cash transaction

Acquisitions by Company A		
CU million	**Company B**	**Company C**
Cash flow statement Investing cash outflow -acquisitions	(100)	(60)
Acquired debt		(40)
Economic effect of acquisition	(100)	(100)

Where to find information about non-cash changes in debt

In 2016 the IASB introduced requirements[5] for companies to provide information in the notes to the accounts that enables investors to evaluate changes in debt, including changes arising from both cash flows and non-cash changes.

One way that companies fulfil this requirement is by disclosing a debt reconciliation from the opening to the closing balance sheet. Although a reconciliation is not mandatory, it is an effective way for companies to meet this requirement and most companies disclose a reconciliation in applying the amendment. This disclosure is generally titled 'debt reconciliation' or a 'reconciliation of liabilities from financing activities'. Sometimes, companies provide the information required about changes in debt as part of a net debt reconciliation.

Illustration of a reconciliation

Note X – Debt Reconciliation						
CU thousands	**20X1**	**Cash flows**	**Non-cash changes**			**20X2**
			Acquired businesses	**Supplier finance**	**Foreign exchange changes**	
Long-term borrowings	22,000	(1,000)	4,500		(150)	25,350
Short-term borrowings	1,000	(500)		1,500	(70)	1,930
Lease liabilities	4,000	(800)	350			3,550
Assets held to hedge LT borrowings	(675)	150				(525)
Total debt	**26,325**	**(2,150)**	**4,850**	**1,500**	**(220)**	**30,305**

5 Amendments to IAS 7 *Statement of Cash Flows*.

Why is information about non-cash changes in debt important for investment analysis?

As investors seek insights into a company's ability to service its debt and to invest for the future and pay dividends, transparency around non-cash changes in debt is essential for an appreciation of the underlying cash flow dynamics of a business. Investors often rebuild the cash flow statement to include both reported cash flows and changes in debt regarded as economically equivalent to cash flows.

Information from the cash flow statement—together with information about movements in debt—can be used to:

- reconcile changes in net debt (from the opening to closing balance sheet) to ensure that cash flows and changes in debt regarded as economically equivalent to cash flows have been identified
- analyse a company's underlying operating cash flows and free cash flow generation
- understand the sources of a company's finance and how those sources have been used over time
- improve confidence in forecasting a company's future cash flows
- better assess a company's ability to service and repay its debts.

Next steps for the IASB: Forthcoming Project on the Cash Flow Statement

The IASB has added a project on the cash flow statement and related matters to its 2022-2026 work plan. The decision to research how companies apply IFRS Accounting Standards related to cash flows reflects investors' responses to the IASB's Third Agenda Consultation[6]. Investors rated a project on the cash flow statement and related matters as a higher priority than any other potential project. Investors said they have difficulty reconciling the statement of cash flows to the other primary financial statements and highlighted the need for greater transparency about non-cash movements.

As part of the research phase of the project, the IASB will define the scope of the project and consider whether the project should aim to review comprehensively its requirements in IFRS Accounting Standards or make more targeted improvements.

6 Feedback Statement on *Third Agenda Consultation*.

To get in touch

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Follow @IFRSFoundation on Twitter to keep up with changes in the world of IFRS Accounting Standards.

This Investor Perspectives has been developed with the intent of providing a more accessible guide for investors to the IASB's recently-issued amendments. As such, the language used may be less technically precise than that found in the amendments and should not be used as a source of interpretation or viewed as complete. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (IASB) or the IFRS Foundation (Foundation). The IASB and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The IASB takes official positions only after extensive review, in accordance with the Foundation's due process.