STAFF PAPER

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IASB Meeting

Project	**Primary Financial Statements**
Paper topic	Initial thoughts on other targeted improvements to the statement of cash flows

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Purpose of paper

1. This paper provides some initial thoughts on the following potential targeted improvements to the statement of cash flows:
   (a) having a consistent starting point for the indirect reconciliation of cash flows; and
   (b) aligning the operating section across the statement of cash flows and the statement(s) of financial performance.

Summary of staff recommendations

2. The staff recommendations are:
   (a) to have a consistent subtotal as a starting point for the indirect reconciliation of cash flows from operating activities. This subtotal could be 'profit before investing, financing and income tax' if this subtotal is included in the statement(s) of financial performance; and
   (b) the Board should not seek to align the operating section of the statement of cash flows with a corresponding section in the statement(s) of financial performance and should instead focus on making targeted improvements to the statement of cash flows, recognising its separate and distinct purpose.

Structure of paper

3. The paper is structured as follows:

   (a) Section 1: Having a consistent starting point for the indirect reconciliation of cash flows.

      (i) Current IFRS requirements (paragraphs 4–5);

      (ii) UK FRC Discussion Paper and feedback received (paragraphs 6–7)

      (iii) What is the problem? (paragraph 8); and

      (iv) Potential approach for addressing this targeted improvement (paragraphs 9–14);

   (b) Section 2: Aligning the operating section across the statement of cash flows and the statement(s) of financial performance

      (i) What is the problem? (paragraph 15); and

      (ii) Potential approach for addressing this targeted improvement (paragraphs 16–18);

Section 1: Having a consistent starting point for the indirect reconciliation of cash flows

Current IFRS requirements

4. Paragraph 20 of IAS 7 *Statement of Cash Flows* requires the use of the 'profit or loss' total as the starting point for the indirect reconciliation of cash flows from operating activities.

5. The Illustrative examples accompanying IAS 7, however, use 'profit before tax' as the starting point for determining net cash flows from operating activities.

UK FRC Discussion Paper and feedback received

6. The UK FRC Discussion Paper included in paragraphs 4.4–4.6 a proposal to provide a reconciliation between a subtotal in the statement of profit or loss that represents

operating income and cash flows from operating activities (including when a direct method cash flow statement is presented).

7. The UK FRC Feedback Statement reported that a majority of respondents agreed that a reconciliation of operating activities should be presented in all cases. A couple of respondents commented that operating profit would need to be defined for this suggestion to be achievable[1].

What is the problem?

8. Paragraph 20 of IAS 7 requires the use of the 'profit or loss' subtotal as a starting for the indirect reconciliation of cash flows from operating activities. However, our research and outreach activities revealed that entities use different starting points for this reconciliation, leading to diversity in practice which users think hinders comparisons and analysis. Some common starting points are 'profit or loss'; 'profit attributable to shareholders', 'profit from continuing operations', 'profit before tax' or 'operating profit'[2].

Potential approach for addressing this targeted improvement

9. We think that the focus should be on having a consistent starting point for the indirect reconciliation of cash flows. The staff observe that the Board could consider either:

   (a) amending IAS 7 to make it clearer that the starting point is the profit or loss subtotal and that no other subtotal can be used as a starting point; or

   (b) requiring as a starting point a subtotal other than profit or loss.

10. If the Board decides to require as a starting point a subtotal *other* than profit or loss, the Board could consider requiring either one of the proposed new subtotals that the Board has tentatively introduced in the statement(s) of financial performance. These two subtotals are:

[1] Refer to paragraph 24 of the UK FRC Feedback Statement.

[2] Refer to paragraphs 52–58 of Agenda Paper 21A of November 2016.

(a) the ‘EBIT’ (or ‘profit before financing and income tax’) subtotal; or

(b) the ‘profit before investing, financing and income tax’ subtotal (that some could view as an equivalent to an ‘operating profit’ subtotal).

11. The staff observe that using any of the subtotals mentioned in paragraph 10(a)–(b) could bring benefits for users because:

(a) users may be able to better understand the link between cash flows from operating activities and the new subtotals introduced for the statement(s) of financial performance; and

(b) it could also potentially simplify the indirect reconciliation of cash flows by removing some reconciling items.

12. **Appendix A** shows some illustrations of how the indirect reconciliation of cash flows could be simplified if the Board decides to require a starting point different from ‘profit or loss’. These illustrations are using the same data from the example included in the Implementation Guidance on IAS 7.

13. The staff observe that using the ‘profit before investing, financing and income tax’ subtotal would be more convenient for users because it would remove the need to reconcile some income/expense items of an investing or financing nature. For example, an entity would not need to include adjustments for foreign exchange losses, interest expense and investment income.

14. Consequently, the staff recommend requiring the ‘profit before investing, financing and income tax’ subtotal as a starting point for the indirect reconciliation of cash flows if that subtotal is included in the statement(s) of financial performance.

Questions for the Board (Section 1)

1. Does the Board support having a consistent starting point for the indirect reconciliation of cash flows?

2. Does the Board agree with the staff view that the starting point for the indirect reconciliation of cash flows could be a ‘profit before investing, financing and income tax’ subtotal if this is included in the statement(s) of financial performance?

Section 2: Aligning the operating section across the statement of cash flows and the statement(s) of financial performance

What is the problem?

15. Our outreach revealed that users think that there should be consistency between how an entity defines its operating profit and its cash flows from operating activities as this will improve their understanding of and insight into an entity's cash conversion cycle (ie the extent to which operating profit is converted to cash)[3].

Potential approach for addressing this targeted improvement

16. When the staff first suggested aligning the operating section across the statement of cash flows and the statement(s) of financial performance, the staff had in mind developing a broad definition of operating activities and/or operating profit for the statement(s) of financial performance. One suggestion was to base this definition on the meaning of 'operating' in paragraph 6 of IAS 7.

17. The staff is of the view that the Board should not seek to align the operating section of the statement of cash flows with a corresponding section in the statement(s) of financial performance at this stage of the project because:

    (a) the Board has had difficulties in the past in trying to define operating profit. This is because stakeholders have different views about what income/expenses should be included in operating profit. At the September 2016 World Standards-setters meeting, participants debated the characteristics of operating profit, but they did not reach a consensus;

    (b) the Board has tentatively decided to introduce a new subtotal (ie 'profit before investing, financing and income tax' subtotal). However, at its November 2017 meeting the Board disagreed with the proposed labelling of this subtotal as an 'operating' subtotal; and

[3] Refer to paragraph 17 of Agenda Paper 21B of December 2016.

(c) the statement of cash flows and statement(s) of financial performance have different purposes and alignment would never be entirely possible; for example, because the statement of cash flows shows cash flows associated with balance sheet movements, not just cash flows associated with flows in the statement(s) of financial performance. Attempting alignment will therefore always be at best partial and will not necessarily aid understanding of either statement or the performance of the entity more generally.

18. The staff is of the view that the Board should remain focussed on making targeted improvements to the statement of cash flows (like the one proposed in Section 1 of this paper or the proposal analysed in Agenda Paper 21C regarding the classification of interest and dividends), some of which may lead to further alignment of the statement of cash flows with the statement(s) of financial performance, but only as a secondary consideration where the underlying logic is consistent.

Question for the Board (Section 2)
1. Does the Board support the staff view that the Board should not seek to align the operating section of the statement of cash flows with a corresponding section in the statement(s) of financial performance and should instead focus on making targeted improvements to the statement of cash flows, recognising its separate and distinct purpose?

19. In addition, and consistent with our discussion with the Accounting Standards Advisory Forum (ASAF) (refer to Agenda Paper 2C from September 2017), the Board could consider making some additional targeted improvements. For instance:

(a) reporting cash flows to acquire property, plant and equipment within operating activities (or as a separate standalone category) if this provides clearer information to investors about the split between an entity's operating activities versus non-operating activities, rather than between operating and investing activities; or,

(b) requiring a separate section for the reporting of income tax.

20. As noted in Agenda Paper 21C, there are some advantages in contemplating a more substantial revision of IAS 7, in order to deal with inconsistent and unclear requirements and drafting. Arguably the suggestion in paragraph 19(a) would be the start of a broader project to improve IAS 7 and could lead to a more substantial change to the investing activities definition in IAS 7. However, it could lead to considerably more work, which might require a standalone project. At present the staff does not advocate going down that route, but would like some guidance on where to draw the line on improvements as part of the current project.

Question for the Board

1. Does the Board support the staff view that the Board should focus on making targeted improvements to the statement of cash flows, recognising its separate and distinct purpose? If so, does the Board agree that the staff should investigate further improvements, such as those noted in paragraph 19, and bring these to a future meeting?

Appendix A – Illustrations of different starting points for the indirect reconciliation of cash flows

A1. We illustrate below the presentation of an indirect reconciliation of cash flows using two different starting points (ie profit before financing and income tax', and 'profit before investing, financing and income tax'). These illustrations use the same data from the example included in the Implementation Guidance in IAS 7.

Consolidated P&L statement in the Implementation Guidance in IAS 7			Restructured P&L statement under staff proposals	
Sales	30,650		Sales	30,650
Cost of sales	(26,000)		Cost of sales	(26,000)
Gross profit	4,650		Gross profit	4,650
Depreciation	(450)		Depreciation	(450)
Administrative and selling expenses	(910)		Administrative and selling expenses	(910)
Interest expense	(400)		*Profit before investing, financing and income tax*	3,290
Investment income	500			
Foreign Exchange loss	(40)		**Income/expenses from investments**	
Profit before tax*	3,350		Investment income	500
Taxes on income	(300)		*Profit before financing and income tax*	3,790
Net profit	3,050		**Financing activities**	
			Interest expense	(400)
			Foreign exchange loss	(40)
			Profit before tax	3,350
			Taxes on income	(300)
			Net profit	3,050

Indirect reconciliation of cash flows

Starting point: profit before tax

Cash flows from operating activities	
Profit before taxation	3,350
Income/expense adjustments for:	
Depreciation	450
Investment income	(500)
Foreign Exchange loss	40
Interest expense	400
	3,740
Movements in working capital	
Increase in trade and other receivables	(500)
Decrease in inventories	1,050
Decrease in trade payables	(1,740)
Cash generated from operations	2,550
Interest paid	(270)
Income taxes paid	(900)
Net cash from operating activities	1,380
Cash flows from investing activities	
Acquisition of subsidiary X net of cash	(550)
Purchase of property, plant and equipment	(350)
Proceeds from sale of equipment	20
Interest received	200
Dividends received	200
Net cash from investing activities	(480)
Cash flows from financing activities	
Proceeds from issue of share capital	250
Proceeds from long-term borrowings	250
Payment of lease liabilities	(90)
Dividends paid	(1,200)
Net cash from financing activities	(790)
Net increase cash and cash equivalents	110
Opening balance	120
Closing balance	230

Starting point: Profit before financing and income tax

Cash flows from operating activities	
Profit before financing and income tax	3,790
Income/expense adjustments for:	
Depreciation	450
Investment income	(500)
	3,740
Movements in working capital	
Increase in trade and other receivables	(500)
Decrease in inventories	1,050
Decrease in trade payables	(1,740)
Cash generated from operations	2,550
Income taxes paid	(900)
Net cash from operating activities	1,650
Cash flows from investing activities	
Acquisition of subsidiary X net of cash	(550)
Purchase of property, plant and equipment	(350)
Proceeds from sale of equipment	20
Interest received	200
Dividends received	200
Net cash from investing activities	(480)
Cash flows from financing activities	
Proceeds from issue of share capital	250
Proceeds from long-term borrowings	250
Payment of lease liabilities	(90)
Dividends paid	(1,200)
Interest paid	(270)
Net cash from financing activities	(1,060)
Net increase cash and cash equivalents	110
Opening balance	120
Closing balance	230

Starting point: Profit before investing, financing and income tax

Cash flows from operating activities	
Profit before investing, financing and income tax	3,290
Income/expense adjustments for:	
Depreciation	450
	3,740
Movements in working capital	
Increase in trade and other receivables	(500)
Decrease in inventories	1,050
Decrease in trade payables	(1,740)
Cash generated from operations	2,550
Income taxes paid	(900)
Net cash from operating activities	1,650
Cash flows from investing activities	
Acquisition of subsidiary X net of cash	(550)
Purchase of property, plant and equipment	(350)
Proceeds from sale of equipment	20
Interest received	200
Dividends received	200
Net cash from investing activities	(480)
Cash flows from financing activities	
Proceeds from issue of share capital	250
Proceeds from long-term borrowings	250
Payment of lease liabilities	(90)
Dividends paid	(1,200)
Interest paid	(270)
Net cash from financing activities	(1,060)
Net increase cash and cash equivalents	110
Opening balance	120
Closing balance	230