Helping Investors Better Understand Cash Flow

Investors Nick Anderson, Gunnar Miller and Tanya Branwhite discuss the merits of the proposed amendments to IAS 7 to provide more information about changes in debt.

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As part of its Disclosure Initiative, the IASB is proposing amendments to IAS 7 *Statement of Cash Flows* that will provide users with information to help them better understand how companies generate and deploy resources. Although the additional disclosure requirements are modest, the proposed changes represent a significant enhancement to financial reporting that many users have championed for a number of years.

The health of a business, small or large, is vitally dependent on cash flow. Ultimately, it is cash that pays the operating costs such as wages and suppliers as well as the debt and equity that funds investment for growth and provides returns to shareholders in the form of dividends. As investors, we often focus on the cash dynamics of individual businesses. Is the company consuming or generating cash and is it able to meet its obligations from this cash flow? How is free cash being deployed and what is the cash return on cash invested? These are key considerations for many users of financial statements.

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While the cash flow statement is the obvious place to start our analysis of cash flows, it is important to recognise that not all of the investments that a company may make are reflected here. Take the example of two companies, identical in all respects apart from their financing structure. The first business is acquired for €100 million. It has no cash or debt. The cost of the acquisition, which is shown as an investing cash flow in the acquiring company's cash flow statement, is €100 million. Now, assume that the second target company has €40 million of debt and is acquired for €60 million. Under these circumstances, the cost shown in the cash flow statement is €60 million, but acquiring the company will also result in assuming a further €40 million of debt when the acquired business is consolidated.

From an economic perspective, these transactions are identical, but the depiction in the cash flow statement is different. Furthermore, in the second transaction the acquiring company is not specifically required to disclose the amount of debt that has been acquired through mergers and acquisition activity. A similar issue occurs when a company invests in plant and equipment, depending on how the investment is financed. If the business chooses to acquire new plant by using its own cash, this appears on the cash flow statement as capital expenditure—but if the investment is financed through the use of finance leases, it is not reflected in the cash flow statement.

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Many preparers recognise that current cash flow disclosures paint an incomplete picture. They appreciate the need for investors and analysts to have a better understanding of the economics of their business and thus voluntarily supplement the customary summary cash flow information. They also provide a reconciliation of net debt from the end of one accounting period to the end of the subsequent period. The net debt reconciliation captures items such as acquired debt and the inception of finance leases, as well as any fair value adjustments made to debt and the impact of foreign exchange movements. With this information, investors are presented with a more comprehensive and 'true and fair' view of the performance and financial position, and hence risk, of their business.

For a number of years, investors and analysts have been asking standard-setters to include a requirement for all companies to provide a net debt reconciliation. While the proposed amendment to IAS 7 does not include a net debt reconciliation, it will ensure that users have the necessary information to undertake a net debt reconciliation themselves. We understand that one of the challenges that the IASB has faced is that there is no definition of net debt in IFRS. Instead, the proposed changes will require companies to reconcile the movement in debt from one period to another. Combining this with the existing information from the cash flow statement will facilitate a net debt reconciliation.

As investors, we appreciate the voluntary disclosure that many companies already provide by way of a net debt reconciliation. The proposed changes should not impose any additional reporting burden on preparers. Equally, all companies are already required to provide a reconciliation of equity. It does not seem unreasonable to help users—in both credit and equity markets—better understand the period-to-period changes in debt, which is the other major source of capital for most businesses.

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The proposed amendments also ask preparers to consider providing additional information to help users better understand issues around liquidity. These may include noting restrictions that impinge on the use of cash and cash equivalent resources, such as tax liabilities that would arise on the repatriation of foreign cash. Understanding any limitations on the use of liquid resource is clearly important. There is still more work to be done. Some users, for instance, would like additional disclosures to better understand the different types of debt financing. While this is not part of the current project, it is hoped that the IASB will review these requirements as part of its wider consideration of disclosures.

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In the meantime, a wide range of users of financial statements will welcome the proposed amendments to IAS 7. These changes help users in both making investment decisions and holding management to account. The IASB should be commended for the proposals and for clearly responding to user feedback in helping investors and analysts in their quest to better understand the economics of individual businesses.

Meet the authors

Nick Anderson is Head of Equity Research at Henderson Global Investors having joined the company from Gartmore in 2011. Nick began his career at Norwich Union Fund Management in 1986, initially specialising in European equities before going on to manage a number of segregated pension funds. He joined Schroder Investment Management in 1997 as an investment manager before becoming Head of Pan European Research. Subsequently, Nick spent six years with Insight Investment, where he was Head of Equity Research. Nick graduated from Durham University in 1986 with a degree in Economics. He is a former member of the UK Accounting Standards Board and an Associate of the CFA Society of the UK.

Gunnar Miller, Managing Director, is the Head of Equity Research Europe for Allianz Global Investors. He joined the firm in 2003. Prior to this he spent one year as an analyst covering European semiconductors at Goldman Sachs in Frankfurt, and four years at Goldman Sachs in New York covering US semiconductor equipment. Prior to joining Goldman Sachs, Gunnar spent five years as an analyst covering US semiconductor equipment and electronics distribution at Paine Webber and Kidder Peabody. Gunnar ranked Number One in the annual US Institutional Investor poll from 1996 through 2001, after being voted Number Two in 1995, and ranked in the top four in the annual Greenwich Associates buy-side poll from 1994 through 2001.

Tanya Branwhite is Director of Equities at the Future Fund in Australia's Sovereign Wealth Fund. Prior to this she was head of Macquarie's Australian Equity Strategy & Economics teams and an Executive Director of Research for the Securities division of Macquarie Group Ltd. Tanya has over 20 years' experience in both stockbroking research and as an investment analyst and is highly regarded and highly rated as an analyst by both domestic and international institutional investors. She was recognised in 2008 by Australian CFO *magazine as Equity Analyst of the Year. Her passion for the integrity of financial reporting is expressed through her support of the Australian Corporate Reporting Users Forum (ACRUF), an analyst and investor group that conducts active dialogue with accounting standard-setters on a worldwide basis.*

The views expressed in this article are those of the authors.