

# Changes in financing liabilities—what does good disclosure look like?



The International Accounting Standards Board (Board) issued an amendment to IAS 7 *Statement of Cash Flows* that became effective in 2017. The amendment requires companies to provide disclosures about changes in liabilities arising from financing activities.

Nick Anderson, a member of the Board and former buy-side investor, discusses the objectives of the new disclosure requirement and explains what companies can do to make their disclosures as useful as possible to users of financial statements.

## What is required?

The amendment requires companies to provide disclosures that enable users of financial statements (users) to evaluate changes in liabilities arising from financing activities. This includes both changes arising from cash flows and non-cash changes.

One way to fulfil this requirement is to provide a reconciliation between the opening and closing balances of those liabilities (IAS 7 reconciliation). Although a reconciliation is not mandatory, it is an effective way to meet the new requirement. Most companies have disclosed a reconciliation in applying the amendment.



## Why is this disclosure so essential for investor analysis?

The health of a business, large or small, depends on cash flow. Consequently, users often focus on the cash dynamics of a business. For example – is the company consuming or generating cash and is it able to meet its cash obligations? How is free cash being deployed and what is the cash return on cash invested? These are key considerations for many users.

However, cash doesn't tell the whole story. For example: take two companies, identical in all respects apart from their financing structure. Company A is acquired for CU100 million. It has no cash or debt. The cost of the acquisition, which is shown as an investing cash flow in the acquirer's cash flow statement, is CU100 million.

Company B has CU40 million of debt and is acquired for CU60 million. Under these circumstances, the cost shown in the acquirer's cash flow statement is CU60 million.

However, acquiring Company B will result in the acquirer assuming a further CU40 million of debt. This will be reflected on the balance sheet when the acquired business is consolidated.

From an economic perspective, these transactions are identical. However, this is evident only if a user has information about movement in both cash and debt:

	Company A CU (million)	Company B CU (million)
<b>Cash flow statement</b>		
Investing cash outflow—acquisitions	(100)	(60)
Acquired debt	–	(40)
<b>Economic effect of acquisition</b>	<b>(100)</b>	<b>(100)</b>

Information about movements in debt—together with the cash flow statement—provide users with a complete understanding of a company’s financing arrangements and transactions. Specifically, the IAS 7 reconciliation (or alternative disclosure) should enable users to:<sup>1</sup>

- check their understanding of a company’s cash flows (and movements in liabilities arising from financing activities that are economically equivalent to cash flows) by enabling them to reconcile between the balance sheet and the cash flow statement;
- improve their confidence in forecasting a company’s future cash flows;
- understand information about sources of finance and how those sources have been used over time; and
- understand a company’s exposure to risks associated with financing.

## Is this different from a ‘net debt reconciliation’?

Yes—but the underlying user information need is the same. A net debt reconciliation is a reconciliation of movements in a net balance comprising debt less cash and cash equivalents. Some companies, including many in the UK, choose to provide a net debt reconciliation. In the above example, the acquirer’s net debt increases by CU100 million in each acquisition. Consequently, many view net debt as a useful economic measure.

However, ‘debt’ is not defined or required to be disclosed by IFRS Standards. This is because finding a commonly agreed definition of debt is difficult.

An IAS 7 reconciliation is different from a net debt reconciliation because it reconciles only movements in liabilities arising from financing activities and not movements in a net balance. However, the IAS 7 reconciliation, together with the cash flow statement, is expected to provide users with all the information they need to analyse a company’s cash and debt in whatever format they find most useful.

### What does good disclosure look like?

An IAS 7 reconciliation will better meet user information needs when it:

- easily reconciles to other areas of the financial statements;
- provides sufficiently granular information;
- provides explanations where necessary; and
- is communicated as simply and clearly as possible.

<sup>1</sup> These objectives are described in paragraph BC10 of IAS 7

## Reconciliation to other areas of the financial statements

Users must be able to link items in the IAS 7 reconciliation to the balance sheet and the cash flow statement.<sup>2</sup> This will enable users to check their understanding of a company's cash flows and financing arrangements.

### Companies can help users by:

- ✓ presenting any additional voluntary information separately in the IAS 7 reconciliation;<sup>3</sup> and
- ✓ ensuring that information in the IAS 7 reconciliation is complete.

## Additional information presented separately

Companies are often aware of the importance of cash and debt information to users, and sometimes provide additional information. For example, some companies:

- define a 'net debt' measure in their financial statements and use this as the basis for the IAS 7 reconciliation; or
- include in their reconciliation items that are not captured by the requirement, but that the company nonetheless considers to be a source of finance (for example, pension liabilities).

Such additional voluntary disclosure can be helpful to users. This will only be the case, however, if the additional information does not prevent users from linking items in the reconciliation to other areas of the financial statements. For example, sometimes a company's 'net debt' cannot easily be derived from the balance sheet (or other areas of the financial statements). This is likely to prevent a user from understanding a complete picture of the company's sources of finance. In such cases, including additional information might do more harm than good.

For this reason, if a company combines any additional voluntary information with an IAS 7 reconciliation, it is required to disclose that additional information separately from changes in liabilities arising from financing activities.<sup>3</sup>

## Complete information

It is also important that an IAS 7 reconciliation includes:

- all liabilities arising from financing activities that appear on the balance sheet (or in the notes); and
- all cash flow statement movements relating to those liabilities.

If the reconciliation does not include this information, users may find it difficult to check their understanding of a company's cash flows.

## Sufficient disaggregation

The appropriate level of disaggregation should be a key consideration for a company preparing an IAS 7 reconciliation. This will enable users to link items in the reconciliation to other areas of the financial statements (see above).

Selecting an appropriate level of disaggregation is also important for other reasons. If information is not sufficiently granular, a user's overall understanding of a company's cash flows will be impaired. It will also limit a user's ability to understand a company's sources of finance.

### Companies can help users by:

- ✓ disaggregating material items that are different in nature;
- ✓ not aggregating items that appear individually elsewhere in the financial statements;
- ✓ avoiding the use of substantial 'other' or 'miscellaneous' items in the IAS 7 reconciliation;
- ✓ disaggregating items such as foreign exchange movements and fair value movements;<sup>4</sup> and
- ✓ disaggregating inflows and outflows to avoid presenting net movements.

<sup>2</sup> This is explicitly required by the amendment—see paragraph 44D of IAS 7

<sup>3</sup> This is explicitly required by the amendment—see paragraph 44E of IAS 7

<sup>4</sup> This is explicitly required by the amendment—see paragraphs 44B(c) and (d) of IAS 7

## Adequate explanation

Companies should also consider whether it is necessary to provide additional explanation of items in the IAS 7 reconciliation.

When making this decision, companies should keep in mind the objectives of the disclosure. Explanation of items in the IAS 7 reconciliation is likely to be needed if it is necessary to enable a user to understand the economic effect of a particular financing arrangement or transaction.

### Companies can help users by explaining:

- ✓ any individually significant or unusual financing transaction;
- ✓ how items such as hedging instruments have been treated in the reconciliation; and
- ✓ the composition of any 'other' or 'miscellaneous' item included in the reconciliation.

## Simple communication

Companies can also help users understand cash flow information by ensuring the IAS 7 reconciliation is communicated as simply as possible. A reconciliation that contains all the necessary information is useful to investors only if it can be easily understood.

Simple communication includes all of the considerations described earlier in this article. However, it is so important that it is worth taking a step back and considering simple communication separately when preparing an IAS 7 reconciliation.

### Companies can help users by:

- ✓ ensuring that a user can easily link opening and closing balances and cash movements in an IAS 7 reconciliation to the same item in the balance sheet, cash flow statement or notes to the financial statements;
- ✓ making use of cross references; and
- ✓ using line item descriptions that are easy to understand and, when appropriate, consistent with those used in other areas of the financial statements.

## Get in touch

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