Topic **Cash flows**

## Purpose

1. The purpose of this meeting is to update ARG members on responses to the boards' proposal to require a direct method cash flow statement.

## Background

2. The boards received 223 comment letters in response to the October 2008 Discussion Paper *Preliminary Views on Financial Statement Presentation*.

3. The Discussion Paper proposed the following changes to the statement of cash flows :

    a. Present operating cash flows using a direct method; an indirect method would not be permitted

    b. "Indirect" operating cash flow information would be found in the proposed reconciliation schedule

    c. Align the line items of the statement of sash flows with those on the (much more disaggregated) statement of comprehensive income.

4. The staff is analyzing the letters and has participated in various meetings with both users and preparers of cash flow statements. Additionally, the staff has obtained feedback from the field test participants on their experiences in preparing a direct method cash flow statement. Many of the letters and meeting participants have questioned the usefulness of presenting operating cash flows using a direct method and highlighted the associated costs.

## Preliminary Overview of Responses[1]

5. Responses to the question "Would a direct method of presenting operating cash flows provide information that is decision useful?" were mixed. Among those who found the direct cash flow statement decision useful were those who prefer the direct cash flow statement because of improved understandability, better predictive value, and increased transparency to the quality of earnings and cash generation. There were also those who found the direct method cash flow statement useful, but no more than an indirect cash flow statement.

6. Negative responses came from both users and preparers of financial statements. The users were not convinced that the direct method of presentation provided more valuable information than the indirect method of presentation and did not feel that the predictive value of the direct method cash flow statement had been sufficiently demonstrated in the discussion paper.

7. Preparer responses echoed those same sentiments in addition to stating that if a direct method cash flow statement were of greater value, management would use this method as a management tool.

8. Furthermore, responses which focused on financial institutions stated that they were not in favour of a cash flow statement (regardless of how presented) being required for banks because it is meaningless for them.

9. Most of those commenting on the proposals related to the cash flow statement agreed with the question "Is a direct method more consistent with the proposed cohesiveness and disaggregation objectives?" However, many observed that an indirect method met those objectives also.

10. The discussion paper asked for information about the costs the boards should consider related to using a direct method to present operating cash flows. Respondents provided information about one time costs and ongoing costs. One time costs would include costs of systems implementation, changes in policies

[1] The staff has not completed its analysis of the comment letters. The purpose of the preliminary overview is to facilitate the discussion at the Analyst Representative Group meeting.

and procedures, and training. Ongoing costs would consist of increased data storage and management, systems maintenance, audit costs, and personnel.

11. The staff believes the system changes and the resulting costs correlate to the level of disaggregation presented in the discussion paper more than the direct method cash flow presentation itself. Based on discussions with preparers as well as feedback from the field test participants, less disaggregation would allow preparers to reconcile to the direct cash flow numbers indirectly, significantly reducing the overall cost to prepare. However, users we have spoken with have stated that a statement of cash flows which is too aggregated (the minimum required by IAS 7) is of little use.

**Possible alternatives for the presentation of cash flows**

12. Through the comment letter review and meetings held, the staff has gained an understanding of the challenges to compiling a direct method cash flow statement that aligns with a highly disaggregated statement of comprehensive income. The staff also has a better understanding of how users utilize cash flow information. Based on that knowledge, the staff is developing alternatives for presenting operating cash flow information in the statement of cash flows that is planning to discuss with the boards in the following months. Some of those alternatives are described below.

**Alternative 1 – Require a direct cash method of presenting operating cash flows with less disaggregation**

13. Alternative 1 would require companies to prepare a direct method cash flow statement without the less disaggregation described in the discussion paper. The resulting statement would not align on a line-by-line basis with the statement of comprehensive income. Minimum line items could be required (e.g. cash received from customers).

14. In conjunction with this alternative, the boards would also need to address whether the indirect-direct or the direct-direct method of preparing a cash flow statement should or may be used.

15. The indirect operating cash flow information currently provided by those presenting an indirect cash flow statement would be presented either in the proposed reconciliation schedule or in the form of a supplemental note (similar to the requirement in FASB Statement 95).

**Alternative 2 – Require an indirect method of presenting operating cash flows that reconciles operating income (as defined in the discussion paper) to operating cash flows**

16. This presentation would begin with Total Operating Income from the statement of comprehensive income as presented in the discussion paper. Alternative 2 aligns the statement of comprehensive income and the statement of cash flows on a "by category" basis. There would not be line-by-line cohesiveness as proposed in the discussion paper. The presentation would differ from current practice because it would begin with *operating* income, not net income, as well as use the categories as defined in the discussion paper versus the definitions in IAS 7. The staff is considering the need to prescribe a greater level of disaggregation for certain line items within a indirect cash flow statement.

**Alternative 3 – Require an indirect cash flow statement (as in Alternative 2) supplemented with reconciliations of key accounts and/or gross cash flow amounts.**

17. One of the criticisms of the indirect method is the inability to follow the changes in balance sheet accounts (in particular working capital accounts) to the changes as they are presented in the cash flow statement. Some possibilities include:

    (a) Reconciliation of opening to ending balances of key items in the notes. These reconciliations would include, for example:

        (i) cash
        (ii) profit or loss
        (iii) foreign currency translation adjustments
        (iv) effects of acquisitions and disposals and
        (v) other non cash transactions.

(b) Presentation of supplemental disclosures about gross receipts and payments in the notes to financial statements, such as cash received from customers.

**Net Debt Reconciliation**

18. The staff is also developing an alternative that includes providing a net debt reconciliation as supplemental information to the statement of cash flows (however it is presented).

## Question to ARG members

19. Do members believe that any of the alternatives discussed above should be pursued? If so, which is your preference?