Project **Financial Statement Presentation**

Topic **Statement of Cash Flows**

Introduction

1. The purpose of this paper is for the IASB and the FASB (collectively, the boards) to reconsider their proposal in the October 2008 discussion paper *Preliminary Views on Financial Statement Presentation* that cash flows from operating, investing, and financing activities should be presented in the statement of cash flows (SCF) using a direct method.

2. The discussion paper proposes that an entity:

   (a) present cash flows from operating, investing and financing activities using a direct method

   (b) classify cash flow items using the definitions of operating, investing and financing activities proposed in the discussion paper (those definitions differ from their current usage in IAS 7 *Statement of Cash Flows* and FASB Accounting Standards Codification (ASC) Topic 230, *Statement of Cash Flows* (formerly FAS 95)

   (c) disaggregate cash receipts and payments in a manner that helps a user of financial statements to understand how those cash flows relate to information presented in the statement of comprehensive income (SCI) and the statement of financial position (SFP)

   (d) present sources and uses of cash **only**, not cash and cash equivalents as currently required in IAS 7 and ASC Topic 230 (formerly FAS 95).

3. In this paper, the staff recommend that the exposure draft:

   (a) retain the proposal that all entities present cash flow information **directly** in the SCF

   (b) modify the direct method of presentation proposed in the discussion paper such that the information about cash flows that users find most beneficial is provided in a cost-effective manner.

4. This paper is divided into the following sections:

   (a) Constituent input and staff research (paragraphs 5—45)

   (b) Issue 1: Presenting information in the SCF (paragraphs46—72)

   (c) Issue 2: Disclosing non-cash information (paragraphs 73—75

   (d) Issue 3: Other cash flow related disclosures (paragraphs 76—81)

   (e) Appendix A: Illustration of alternatives

   (f) Appendix B: CFA Survey Report.

Constituent input and staff research

Comment letter responses

5. Question 19 in the discussion paper asks whether a direct method of presenting operating cash flows provides decision-useful information. The responses to that question were mixed.

6. Most preparer respondents think the utility provided by a direct-method SCF does not outweigh:

   (a) the utility of the information provided by an indirect-method SCF

   (b) the costs to prepare a direct-method SCF. (See paragraphs 19—27 for information about the cost considerations of preparing a direct-method SCF.)

7. Some preparer respondents contend that **if** a direct method presentation of operating cash flows produced more decision-useful information, management would use that information to manage their business. However, one user points out that management's incentives often are aligned with profit and loss metrics where investors are interested in cash generation metrics (such as free cash flow

or discounted future cash flow). Thus, what management finds useful may not reflect what is useful to a user of financial statements.

8. Some respondents (that are not preparers of financial statements) argue that the direct-method for presenting operating cash flows **does** provide decision-useful information. However, many of those respondents agree with preparer respondents that the marginal benefit of direct cash flow information does not outweigh the costs. A minority of user respondents state that operating cash flow information prepared either directly or indirectly provides decision-useful information, but neither method of preparation provides information that is more useful than the other.

9. User respondents that support the direct method of presenting operating cash flows think that presenting cash receipt and cash payment line items in an SCF:

   (a) has better predictive value than only being presented with the changes in asset and liability balances

   (b) increases transparency to the quality of earnings and cash generation

   (c) is much easier to understand than the indirect method because it presents the information in a manner that financial statement users can readily interpret.

10. A user respondent explains:

> [A direct method cash flow] offers insights into the quality of revenues and earnings, and the characteristics of the cash conversion cycle, which are not available from an indirect method of reporting cash flow from operating activities. The [direct method] is also consistent with and achieves the greater relevance of disclosure of gross rather than net amounts.
>
> The increased focus on cash generation will further anchor valuations in free cash generation, helping to reduce fraud, reduce “earnings management,” and possibly dampening speculative excesses through heightened awareness of the required growth expectations to sustain valuations.
>
> Companies with low cash conversion will be under greater scrutiny, driving out poor capital allocation or prompting more sensible discussions about long-term investment projects.
>
> Small investors will have a straightforward way to think about the business via the direct cash flow statement, similar to how many small businesses are run. This may help to protect small investors.

11. Respondents provided examples of how direct-method information might be used. A financial statement user might:

    (a) compare similar types of cash receipts and payments across entities

    (b) develop questions about how the amount, timing, and uncertainty of cash flows differ from revenue and expense elements in the statement of comprehensive income (SCI)

    (c) perform a more meaningful cash flow variance analysis

    (d) analyze the sensitivity of cash flows due to volume changes (gross cash receipts and cash payments may respond differently to changes in activity).

12. However, one respondent asserts that "[B]y and large analysts favor the indirect method. The indirect method along with a proper income statement disaggregation, we think, is the right set of information needed from a user's perspective." They go on to explain that most forecasts start with income on an accrual basis because cash flows are inherently unpredictable.

13. Some user respondents think that the level of detail for direct method operating cash flows proposed in the discussion paper may be unnecessary. Those respondents think that an improved indirect-method SCF would be better than requiring a SCF prepared using a direct method. For example, a credit analyst respondent states:

    > Many of our analysts feel there is no need for the increased level of detail that such a direct method as proposed would present, and would be happy with a clear indirect method statement for the purposes of their analysis. We generally believe the proposed detail of direct cash flows may not strictly be necessary for analysis.

14. Some respondents that are not necessarily in favor of requiring a direct method for presenting operating cash flow information do recognize the value in **some** direct cash flow information:

    > Separate disclosure of certain direct components of operating cash flows could still be helpful without requiring a fully direct and very detailed statement. We suggest that it could be better for the Boards to build consensus around a few key direct elements if a full direct statement is not required. For those that may be shown, it would be useful to provide the indirect derivation of such amounts.

15. In summary, preparer respondents do not support a direct-method SCF, while the views of all other respondents are mixed.

April 2009 meeting

16. In April 2009, the staff held an informal meeting with approximately twenty preparers and users of financial statements to discuss the SCF. The purpose of the meeting was to better understand the information users want about operating cash flows and the barriers to and costs of providing that information.

17. Similar to the comment letter responses, the views of users of financial statements were mixed: some prefer a direct-method SCF, others an indirect-method SCF. At that meeting it became clear that the users of financial statements that support a direct-method SCF also find value in the information provided by an indirect-method SCF. Therefore, those users of financial statements would like a direct-method SCF supplemented with an indirect reconciliation (ie details about changes in assets and liabilities that comprise working capital).

18. The users of financial statements that participated in the April 2009 meeting said that a direct-method SCF prepared using existing standards provides information with little utility. That is largely because the cash receipts and payments from operating activities are highly aggregated (for example, cash paid is usually presented on three lines: cash paid for taxes, cash paid for interest, and cash paid for labor, materials, and other operating expenses). As a comment letter respondent noted, "highly summarized information is of little analytical value." It appears that a greater level of disaggregation than what is provided today (however, not as much as presented in the discussion paper) is needed to make a direct-method SCF useful.

Cost considerations

19. Question 20 in the discussion paper asks respondents about the costs associated with using a direct method to present operating cash flows. Respondents to the discussion paper used phrases such as "extremely costly" and "significant costs" in reference to the costs associated with presenting a direct-method SCF.

20. A critical factor in evaluating the responses to question 20 is that respondents addressed the cost issue as it relates to a direct-method SCF *disaggregated by function and nature*, as proposed in the discussion paper.

21. Respondents explain that disaggregating cash flow information to align with the by-function and by-nature information on the SCI adds complexity to the preparation of the SCF. That is because cash flows must be captured at the **transaction level**. Respondents note that is "by far the most costly" method of preparing a direct-method SCF.

22. Preparing a direct-method SCF that disaggregates by-function and by-nature cash flows will result in one-time costs as well as ongoing costs. Respondents inform the boards that:

    (a) one-time costs might include:

        (i) major enterprise-wide systems modifications or replacements that would also require business process analysis and redesign, validation testing and staff training

        (ii) documentation of systems and processes for internal control purposes

        (iii) audit fees associated with any new processes or systems.

    (b) ongoing costs might include:

        (i) increased data storage and management

        (ii) increased personnel costs due to additional upfront transaction processing

        (iii) internal and external audit costs.

23. During the April 2009 cash flow meeting, preparers said that the difficulties in compiling a direct-method SCF as presented in the discussion paper stem from:

    (a) having a central purchasing function

    (b) having complex multinational operations

    (c) operating on varied computer platforms

    (d) the effects of foreign currency exchange

    (e) transfer pricing.

24. Implementation cost estimates provided in the comment letters and by field test participants range from at a very minimum, more than $1 million (a company with annual revenues between $20-25 billion) to $20-$30 million (a company

with annual revenues between $25-30 billion) to $50 million (for a company with annual revenues between $100-110 billion).

25. A preparer respondent suggested that some of the complexity and cost could be reduced if the SCF did not need to align with the SCI at the line-item level (or, alternatively, if the SCI itself were less disaggregated than currently proposed). That is because an entity could use a **derived approach** (back into the amounts) to prepare the SCF rather than an approach that starts at the transaction level or it could use existing systems and sub-ledgers to compile the less disaggregated information.

26. After gaining an understanding of existing systems, the staff think that a less disaggregated direct-method SCF would result in lower implementation and ongoing costs. Some preparers agree that less disaggregation, in particular not being required to allocate cash flows by function, would result in far lower costs. However, at least one preparer has stated that the costs to prepare a direct-method SCF would be the same no matter the level of disaggregation.

27. Although preparers provided most of the input on costs, some user respondents did provide their views. One user respondent said the following about the costs to prepare a direct-method SCF:

> … investors will balance any costs they must bear for individual company accounting system updates against the savings all investors in the aggregate will realize. These savings will result from reduced analytical time and effort, elimination of cash flow estimation errors, investors' enhanced ability to make better, more informed investment decisions, and a lower cost of capital. Finally, if managers, with the benefit of these upgrades are able to make more informed decisions, all investors, managers, employees, customers, and suppliers alike, will benefit.

Feedback from field test participants

Preparers

28. Preparer participants had similar views about the proposed direct-method SCF as the preparers that responded to the discussion paper. In the survey about the recast financial statements, preparer participants indicate that the direct method SCF was the least useful aspect of the proposed presentation model in communicating their entity's financial results.

Analysts

29. The direct method presentation of cash flows was ranked by analysts as the third most useful aspect of the proposed presentation model behind increased disaggregation and the separation of operating and financing activities. The participants that reviewed the Bank Corp financial statements rated the direct method statement of cash flows as the second most useful aspect of the proposed model.

30. Less than 30% of the analyst participants indicate that the non-recast (indirect method) SCF communicates the relationship between an entity's cash flows and its assets, liabilities, income, expense, gains, and losses for the period. In comparison, over 60% found that the recast (direct method) SCF communicate that relationship *well* or *very well*.

31. The recast SCFs were found to be more decision useful than the non-recast version by 70% of the analyst participants. (See Figure A below.)

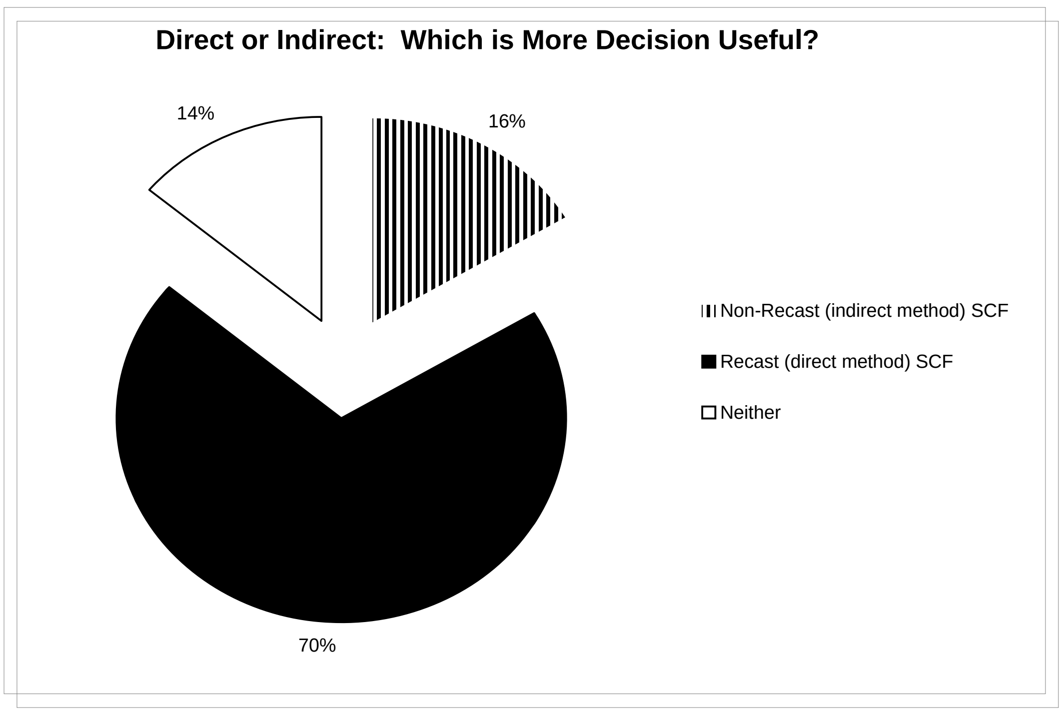

Figure A

32. Several analyst participants comment that the direct method presentation of cash flows is more intuitive and made it easier to grasp the actual sources and uses of cash flows. Many state that the relationship between the recast SCF and the other statements is improved due to the increased disaggregation and

alignment of sections and categories across the statements. However, participants also indicate the recast SCF needs more information on working capital movements and interest income and expense. Some request a reconciliation between the indirect and direct method of presenting cash flows. The staff interpret those comments as agreeing with those who request additional or more transparent information regarding working capital movements.

33. Fifty-six percent of the analyst participants indicate that the non-recast cash flow statements would be more decision-useful with more disaggregation; however, that was not the only factor affecting usefulness. One-third of the participants indicate that the decision-usefulness of the non-recast cash flow statements is affected by something other than disaggregation. Specifically, several participants commented that **the non-cash items in the indirect SCF do not necessarily represent cash flows and can be remote from the actual economic activity of an entity making it difficult to assess the quality of reported earnings**.

Other user input

ARG survey

34. The staff sent an informal survey to members of the IASB's Analyst Representative Group (ARG) following discussion of cash flows at their June 2009 meeting. Ten members responded to that survey; those members were divided into two groups: CFA Institute members (5) and others (5). The CFA Institute group believes that the direct method SCF is intuitive and useful. Their comments related primarily to information on receivables and cash received. The other group believes that the direct method does not provide a more useful SCF, however, one member of that group stated that there would be value in knowing the amount of cash received from customers.

35. Neither group considered a direct method SCF as presented today as useful, and each group suggested further disaggregation of operating cash outflows between labor, raw materials, and finished goods.

36. When asked how a direct-method SCF should be presented, several ARG members said that by-nature disaggregation of cash flows would make the most sense, as by-function cash flows are typically not comparable across entities.

CFA Institute survey

37. The CFA Institute sent an eight-question survey to 12,000 of its members in July 2009. The purpose of that survey was to obtain CFA Institute member feedback on issues related to cash flows from operating activities and their presentation in direct and indirect method cash flow statements. A total of 541 responses were received.

38. A total of 63% either *strongly agreed* or *agreed* that information about operating cash flows presented using the direct method would better enable them to forecast future cash flows of an entity (compared to the indirect method). Sixty-three percent also *strongly agreed* or *agreed* that this information would be more useful in assessing a company's quality of earnings compared to the indirect method. (See Appendix B for the CFA Institute survey report.)

39. Survey respondents were asked to comment on the direct-method SCF from the discussion paper. Although the results detailed in the previous paragraph show an overall positive response to the direct-method SCF, many participants commented that the level of disaggregation was too much. A few participants felt disaggregating a few significant outflows would be adequate. Others commented that the level of detail could put entities at a competitive disadvantage. The staff interpret those responses to mean that the direct-method SCF would be useful even without the level of disaggregation in the discussion paper.

Academic research

40. Although not specifically referenced in the comment letter responses, the CFA Institute has previously said that "it is impossible for even the most skilled analyst to create a reliable direct method cash flow statement for most

companies from **existing** reported data."[1] That assertion is supported by academic research documenting significant (meaning differing from total operating cash flow by at least 3%) articulation errors in up to 75 percent of the indirect cash flow statements analyzed.[2] This research shows that estimates of operating cash flows (such as cash received from customers and cash paid to suppliers) when derived from indirect cash flow statements differ significantly from the amounts reported on a direct basis.

41. Academic research has further shown that models predicting future cash flows are more accurate when based on direct-method SCF line items than when using information from an indirect-method SCF.[3] Furthermore, recent research demonstrates that current market prices contain more information about a company's future earnings and operating cash flow when the company provides direct-method cash flow statements, suggesting that the direct method is more useful to market participants in valuing firms.[4]

42. In addition, other academic research shows an additional benefit in that analysts and loan officers make fewer processing errors and exhibit more consistent judgments when basing their decisions on direct cash flow information than when given indirect cash flow information.[5]

Advisory group input

43. In July 2009, the staff received feedback from the project's two advisory groups: the Joint International Group and Financial Institution Advisory Group. Participants seemed to see value in select direct information while not necessarily calling for a direct-method SCF. Participants also seemed in favour

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[1] CFA Institute. *A Comprehensive Business Reporting Model: Financial Reporting for Investors.* (Charlottesville, VA: CFA Institute, 2007.)

[2] Paul R. Bahnson, Paul B. Miller, and Bruce P. Budge, "Nonarticulation in Cash Flow Statements and Implications for Education, Research, and Practice," *(Accounting Horizons, 1996.)*

[3] Gopal Krishnan and James Largay III, "The Predictive Ability of Direct Method Cash Flow Information," *(Journal of Business Finance and Accounting, 2000.)*

[4] Steven Orpurt and Yoonseok Zang, "Are Direct Cash Flow Disclosures Informative? A Revisit,"*(The Accounting Review, May 2009.)*

[5] Thomas P. Klammer and Sarah A. Reed "Operating Cash Flow Formats: Does Format Influence Decisions?" *(Journal of Accounting and Public Policy, 1990.)*

of maintaining an indirect-method SCF while requiring direct measures such as cash from customers.

Financial services entities

44. Respondents representing both users and preparers of bank financial statements state that banks (and other financial services entities such as insurance companies) should not have to present a statement of cash flows. Their reasons include the following:

    (a) The SCF does not give an indication of the liquidity risk a bank is exposed to on an ongoing basis

    (b) Analysts that cover financial services entities do not use the SCF

    (c) Banks do not use the SCF as a management tool

    (d) The requirements of IFRS 7 *Financial Instruments: Disclosure* provide more useful information than a SCF because it enables a user of financial statements to assess the liquidity risks arising from banks' financial assets and financial liabilities.

45. However, as noted in paragraph 29, those who reviewed Bank Corp. financial statements as part of the field test found the direct-method SCF to be the second most useful change proposed in the discussion paper.

Issue 1: Presenting information in the statement of cash flows

46. In light of all the feedback received, the staff think that the financial statements should include:

    (a) some indirect operating cash flow information

    (b) some direct operating cash flow information

    (c) direct method presentation of financing and other non-operating cash flows.

47. The staff developed two alternative ways to present that information in the financial statements. Those alternatives are summarised in the following table, described in paragraphs 48—61, and illustrated in Appendix A.

	Alternative 1 - Direct Cash Flow Statement plus supplemental disclosures	Alternative 2 - Indirect Cash Flow Statement plus supplemental disclosures
FEATURES	**Operating:** **a.** Present significant or material cash inflows of the entity (i.e. cash from customers). **b.** Present significant or material cash outflows of the entity (i.e. cash paid to employees, cash paid to suppliers, cash paid for fixed assets) **Financing and other non-operating:** **c.** Present direct cash flow information for those activities which are not included in Operating Income (i.e. interest paid, cash received from issuance of debt)	**Operating:** **a.** Reconcile Operating Income (as defined in this project) to Operating Cash Flows - Disaggregate "net change items" in the operating category to correspond with SFP line items **b.** Present direct cash flow information for other business activities not included in the reconciliation of Operating Income to Operating Cash Flows (i.e. cash paid for fixed assets) **Financing and other non-operating:** **c.** Present direct cash flow information for those activities which are not included in Operating Income (i.e. interest paid, cash received from issuance of debt)
DISCLOSURES	**Disclosure 1** - Reconciliation of Operating Income to Operating Cash Flows.	**Disclosure 1** - Disclose cash from customers **Disclosure 2** - Reconcile articulation differences

Alternative 1 – A less disaggregated direct-method statement of cash flows with indirect information in the notes

48. **Alternative 1** requires a **direct-method presentation of the SCF**. That is, an entity would be required to present line items for cash receipts and payments in each section (and category) in the SCF.

49. Alternative 1 also requires an entity to **present indirect operating cash flow information** in the notes to financial statements. That is, an entity would reconcile operating income to cash flows from operating activities. Doing so will maintain the information that users currently find useful, such as changes in working capital assets and liabilities.

50. Consistent with the disaggregation principles recommended in IASB agenda paper 7C/FASB memorandum 70C, the staff recommend **a principled approach to disaggregation** on the SCF that would result in an entity's significant or material cash flows being apparent to a user of its financial statements.

51. Applying this approach could result in

    (a) cash receipts for operating activities being disaggregated and presented based on the sources of those receipts (i.e. cash received from customers) and

(b) cash payments for operating activities being disaggregated and presented based on the recipient of the cash or the nature of the purchase (cash paid for labor, cash paid to raw material suppliers, etc.).

52. In addition, an entity would present amounts for the receipts and disbursements that are currently defined as investing and financing activities. However, the classification of those receipts and disbursements will change based on the boards' definition and category decisions.

53. Alternative 1 requires an entity to present and describe its cash flow line items in a manner that helps a user of the financial statements understand how those cash receipts and payments relate to information presented in the SFP and the SCI. However, Alternative 1 does not require line-by-line alignment with the SCI as proposed in the discussion paper. Therefore, an Alternative 1 SCF will have **fewer** line items than illustrated and described in the discussion paper but **more** line items than currently required to be presented in a direct-method SCF. Alternative 1 is illustrated in Appendix A.

Alternative 2 – An improved indirect-method statement of cash flow with supplemental disclosures

54. Alternative 2 **requires an entity to reconcile its operating income to cash flows from operating activities** while presenting cash inflows and outflows from other categories (such as cash flows from financing activities) directly in the SCF.

55. The Alternative 2 SCF is similar to the indirect-method SCF most entities present today except that:

(a) the reconciliation of income to cash flows from operating activities would **begin with *total operating income*** from the SCI rather than *net income*.

(b) an entity would **disaggregate *net change items* in the operating section** in the SCF to correspond with the line items presented on the SFP. A *net change item* is the change in a deferral of past operating receipts and payments or the change in accruals of operating cash receipts and disbursements.

(c) an entity would include direct cash flow information for those items that are not tied to income or expense but are operating activities (i.e. purchase of fixed assets).

56. Starting with operating income (instead of net income) and disaggregating the net change items should make the relationships of the changes in working capital and other non-current asset and liability accounts more clear. For example, *change in receivables and other assets* in an indirect-method SCF could be the sum of several items, such as accounts receivable, current assets, non-current assets, and tax refunds. If those components are disaggregated in the SCF, a user of financial statements would have a better view into the cash and non-cash changes of each line in the SFP. For instance, if *change in deferred revenues* was disaggregated, cash collected in advance from customers would be more discernable, thus enabling assumptions to be made about cash and revenues in future periods.

57. The suggested improvements to the SCF described above for Alternative 2 do not address all of the shortcomings that are present in today's indirect statement. Therefore, Alternative 2 includes two supplemental disclosures that should provide users of financial statements with more decision-useful information: disclosure of **cash from customers** and **reconciliation of articulation differences**. Those disclosures are described in the following paragraphs.

Disclosure of cash from customers

58. One criticism of an indirect-method SCF is that it does not provide information about cash flows that users of financial statements are especially interested in, particularly *cash from customers*. Disclosure of *cash from customers* could provide additional information about an entity's ability to convert revenues to cash. Because users of financial statements might find this information useful in assessing conversion of revenues to cash, the Alternative 2 indirect-method SCF would be supplemented with disclosure of cash from customers.

Disclosure of articulation differences

59. Another criticism of the indirect method is that the changes in SFP accounts (in particular working capital accounts) do not usually align (articulate) with the changes as they are presented in the SCF. For example, *change in accounts payable* as presented in an indirect-method SCF is usually a different amount than the change in that line item on the SFP. The difference normally results from items such as acquisitions, divestitures, foreign exchange, and reclassifications which affect the accounts payable balance but are not the result of operating cash flows. Detailing that difference in a separate disclosure may help a user of financial statements to align the SFP and the SCF (see the supplemental disclosures in Appendix A). Therefore, Alternative 2 includes this supplemental disclosure requirement.

60. One alternative explored for the reconciliation schedule in IASB agenda paper 7B/FASB memorandum 70B is a series of disclosures that analyze the changes in significant SFP line items. If that disclosure is required, the disclosure of articulation differences described in paragraph 60 above would be included in the analysis of changes in significant line items. Therefore, there would be no need for this supplemental "articulation" disclosure. The staff prefer the disclosure analyzing changes in significant line items described in Alternative C of IASB agenda paper 7B/FASB memorandum 70B to a disclosure of articulation differences. That is because the former provides more information and begins and ends with amounts on the SFP.

61. If the boards decide to require a note disclosure analyzing the changes in significant line items, not only would the separate articulation note included in Alternative 2 not be necessary, but the disaggregation of "net change items" detailed in paragraph 56 of this paper also would not be necessary. That is because those changes presumably would be included in the analysis of changes in significant line items.

Staff analysis

62. The staff continue to think that direct information about operating cash receipts and payments should be presented in the SCF. The results of the field test and

the CFA Institute survey clearly indicate significant support from users of financial statements for a direct method of presenting cash flows.

63. The staff believe the boards should strive to provide users of financial statements with the cash flow information they need at the lowest cost to preparers. Based on feedback received, users are looking for:

    (a) insight into quality of earnings

    (b) information on changes in working capital

    (c) comparisons of cash movements across periods and entities

    (d) reduced modeling risk

    (e) enhanced forecasting abilities.

64. In the staff's opinion, Alternative 1 would address all of the user needs described above; Alternative 2 would address some of those needs, but not all.

65. If not for cost concerns, the staff would not hesitate to recommend that all entities be required to present a direct-method SCF as proposed in the discussion paper as well as supplemental information reconciling operating income to cash flows from operating activities.

66. The cost concerns raised by preparers of financial statements about the direct-method SCF proposed in the discussion paper proposal seem to relate primarily to:

    (a) the level of disaggregation (by function and by nature to align with the SCI)

    (b) the presumption that an entity would have to completely reengineer their systems to track cash receipts and disbursements related to their by-function and by-nature expenses.

67. Alterative 1 requires a principled approach to presenting cash inflows and outflows—an entity would present significant or material cash flows from its activities. The approach an entity uses to determine the operating cash flows presented on a direct-method SCF (ie, at the transaction level or derived) would not be prescribed in the standard. Therefore, the cost concerns related to

preparing a highly disaggregated SCF (see paragraph 21) should not be a factor in determining what method of presentation to require.

68. An entity **will** incur implementation costs to present the direct cash flow information required by Alternative 1, but the staff assert that the necessary system changes would be far less costly than tracking the cash flows related to by-function and by-nature expenses. In follow-up conversations**,** some preparers that participated in the April 2009 meeting said that **a direct-method SCF like that in Alternative 1** (ie, does not require disaggregation by function) **would be significantly less costly to prepare** than the direct-method SCF proposed in the discussion paper**.**

69. Alternative 2 is an improvement to the SCF that most entities present today. Therefore, there also will be costs associated with implementing that alternative. The staff think that for most entities, the costs to implement Alternative 2 will be less than the costs to implement Alternative 1.

Staff recommendation

70. The staff recommend Alternative 1**—**a direct-method SCF accompanied by an indirect reconciliation of operating income to operating cash flows. The staff believe that the changes to the direct-method SCF proposed in Alternative 1 will provide benefits to users of financial statements and reduce the costs that an entity would have incurred in implementing the direct-method SCF proposed in the discussion paper. The benefits to the user include:

    (a) presentation of cash flow information that will be more intuitive and understandable to a broad-range of users of financial statements

    (b) improved insight into the cash conversion cycle and quality of earnings

    (c) when accompanied by an indirect reconciliation of operating cash flows, information that links the SFP and the SCF

    (d) information which, based on academic research, is superior to any derivations even the most skilled analyst would arrive at

    (e) the ability to develop trends and comparisons not currently achievable.

71. Alternative 2 is less costly, but it does not meet user needs to the same extent Alternative 1 does. An indirect-method SCF, no matter how improved:

(a) is not intuitive

(b) leaves a user unable to analyze trends of actual cash movements

(c) leads to processing errors according to academic research

(d) requires analysts to continue to use indirect cash flow information to derive direct cash flow metrics.

Additionally, analysts who follow financial services entities view a direct-method SCF as potentially useful, whereas they find an indirect-method SCF useless.

72. The staff also recommend that whichever method of presentation is chosen that there be **only one method of presenting cash flows** permitted in the exposure draft. That recommendation is consistent with both boards' stated preference to limit alternatives in accounting standards.

Questions 1–3 on presenting information on the SCF
Q1. The staff recommend that an entity be required to present its SCF using the direct method described in Alternative 1 and also present an indirect reconciliation of operating income to operating cash flows in the notes to financial statements. **Do the boards agree with that recommendation?** **Q2.** If the boards do not agree with the staff recommendation in Q1, do the boards support Alternative 2 as described in paragraph 54-61? **Q3.** The staff recommend that the exposure draft require a single method of presenting cash flows and not provide a choice of methods. **Do the boards agree with that recommendation?**

Issue 2: Disclosing non-cash information

73. The discussion paper proposes that an entity should disclose all relevant information about its noncash activities unless that information is presented elsewhere in the financial statements (consistent with current IFRS and US GAAP).

74. Examples of non-cash transactions that an entity might disclose include:

    (a) acquisition of assets by directly assuming related liabilities

    (b) purchase of a building with a seller financed mortgage

    (c) conversion of debt to equity

    (d) acquisition of an asset through a gift.

75. Information about non-cash activities is important to understanding an entity's asset and capital positions. Therefore, the staff recommend that the boards retain the proposal in the discussion paper that an entity disclose in the notes to financial statements all relevant information about its non-cash activities.

Question 4 on disclosing non cash information
Q4. The staff recommend that an entity be required to disclose information about its non-cash activities in the notes to financial statements. **Do the boards agree with the staff recommendation?**

Issue 3: Other cash flow related disclosures

76. Respondents to the discussion paper asked for additional cash flow information to be presented in the financial statements. Based on that input, the staff would like the boards to consider the following cash flow disclosures for inclusion in the exposure draft:

    (a) cash flows by segment

    (b) limits on access to cash due to repatriation taxes or other restrictions.

Cash flow by segment

77. A few respondents to the discussion paper note that cash flows by segment would be a meaningful disclosure. One preparer noted that they disclose this information and their analysts find it useful. The staff also received feedback during its meetings with constituents that users of financial statements may find information about cash flows by segment useful in predicting future cash flows.

78. Consistent with the staff view expressed in IASB agenda paper 7C/FASB memorandum 70C on disaggregation, the staff believe that information about

cash flows by segment would better assist a user of financial statements in predicting an entity's future cash flows. If the boards are interested in disclosing cash flow information by segment, the staff will do further research on ways to present that information for discussion at a future meeting.

Repatriation taxes and other restrictions

79. A cash flow statement depicts a consolidated view of cash flows; however, it does not highlight how access to that cash may be limited by the tax impacts of transferring those funds out of and into specific jurisdictions at a later date. US GAAP does not require disclosure of restrictions due to exchange controls or legal restrictions. (Note: IAS 7 paragraphs 48 and 49 call for disclosure of significant cash balances that are not available to the group due to, for example, exchange controls and other legal restrictions. ASC reference 205-10-S99-6 (S-X Rule 5-04) requires disclosure of restricted net assets of consolidated subsidiaries when those net assets exceed 25 percent of consolidated net assets as of the end of the most recently completed fiscal year.)

80. The staff believe that information about an entity's access to cash, both implicit or explicit, could be useful to a capital provider and should be considered for inclusion in the exposure draft.

Staff recommendation

81. The staff recommend that an entity present information about repatriation limitations and other restrictions on cash in the notes to financial.

Questions 5 on other cash flow related disclosures
Q5. The staff recommend that an entity present information about repatriation limitations and other restrictions in the notes to financial statements. **Do the boards agree with that recommendation?**

Appendix A

Alternative 1- Direct-Method SCF

CONSOLIDATED STATEMENT OF CASH FLOWS (TOOLCO)	
CASH FLOWS FROM BUSINESS ACTIVITIES	**2010**
CASH FLOWS FROM OPERATING ACTIVITIES	
Total cash collected from customers	2,812,741
Labor outflows	(810,000)
Materials outflows	(935,554)
Other business related cash outflows	(260,728)
Settlement of stock-based compensation	(3,602)
Lease payment	(50,000)
Pension outflows	(340,200)
Capital expenditures	(54,000)
Disposal of property, plant, and equipment	37,650
Investment in affiliates*	
Settlement of cash flow hedge	3,402
Sale of receivables	8,000
Net cash from operating activities	**407,709**
CASH FLOWS FROM INVESTING ACTIVITIES	
Dividends received	54,000
Purchase of available-for-sale securities*	
Sale of available-for-sale securities	56,100
Net cash from investing activities	**110,100**
Net cash from business activities	**517,809**
CASH FLOWS FROM FINANCING ACTIVITIES	
Dividends paid	(86,400)
Interest paid	(83,514)
Interest received on cash	8,619
Proceeds from issuance of short-term debt	162,000
Proceeds from issuance of long-term debt*	
Proceeds from reissue of treasury stock	84,240
Net cash from financing activities	**84,945**
Net cash from continuing operations before taxes	**602,754**
Cash paid for current tax expense	(281,221)
Change in cash before equity items and disc. ops.	**321,533**
CASH FLOWS FROM DISCONTINUED OPERATIONS	
Cash outflows from discontinued operations	(12,582)
Total change in cash from discontinued operations	**(12,582)**
Change in cash before foreign exchange	**308,951**
Effect of foreign exchange	3,209
Change in cash	**312,160**
Beginning cash	861,941
Ending cash	**1,174,101**

* Line items without values left as placeholders

Alternative 1 – Direct-Method SCF (continued)

Note X - Indirect Reconciliaiton of Operating Cash Flows

	2010
OPERATING ACTIVITITES	
Operating earnings	916,137
Adjustment to reconcile operating earnings to cash flow from operating activities of continuing operations:	
Loss(earnings) in equity of associate A	(23,760)
Realized loss(gain) on future contracts	(3,996)
Loss(gain) on disposal of property, plant and equipment	(22,650)
Loss on sale of accounts receivable	4,987
Non-cash charges and credits	
Depreciation and amortization	279,120
Bad debt expense	23,068
Loss on obsolete and damaged inventory	29,000
Impairment loss on goodwill*	
Litigation expense	1,998
Net changes in working capital deferrals and accruals	
Account receivable, trade	(420,650)
Other current assets	(8,402)
Inventory	60,250
Advances from customers	(244,605)
Account payable	80,556
Change in other assets and liabilities	(216,896)
Cash inflows and outflows from other operating activities	
Settlement of cash flow hedge contract	3,402
Sale of property, plant, and equipment	37,650
Capital expenditure	(54,000)
Cash paid on lease liability	(33,500)
CASH FLOW FROM OPERATING ACTIVITIES	**407,709**

* Line items without values left as placeholders

Alternative 2 - Indirect-Method SCF

CONSOLIDATED STATEMENT OF CASH FLOWS (TOOLCO)

	2010
OPERATING ACTIVITITES	
Operating earnings	916,137
Adjustment to reconcile operating earnings to cash flow from operating activities of continuing operations:	
Loss(earnings) in equity of associate A	(23,760)
Realized loss(gain) on future contracts	(3,996)
Loss(gain) on disposal of property, plant and equipment	(22,650)
Loss on sale of accounts receivable	4,987
Non-cash charges and credits	
Depreciation and amortization	279,120
Bad debt expense	23,068
Loss on obsolete and damaged inventory	29,000
Impairment loss on goodwill*	
Litigation expense	1,998
Net changes in working capital deferrals and accruals	
Account receivable, trade	(420,650)
Other current assets	(8,402)
Inventory	60,250
Advances from customers	(244,605)
Account payable	80,556
Change in other assets and liabilities	(216,896)
Cash inflows and outflows from other operating activities	
Settlement of cash flow hedge contract	3,402
Sale of property, plant, and equipment	37,650
Capital expenditure	(54,000)
Cash paid on lease liability	(33,500)
CASH FLOW FROM OPERATING ACTIVITIES	**407,709**
INVESTING ACTIVITIES	
Dividends received	54,000
Purchase of available-for-sale securities*	
Sale of available-for-sale securities	56,100
CASH FLOW FROM INVESTING ACTIVITIES	**110,100**
Net cash from business activities	**517,809**
FINANCING ACTIVITIES	
Dividends paid	(86,400)
Interest paid	(83,514)
Interest received on cash	8,619
Proceeds from issuance of short-term debt	162,000
Proceeds from issuance of long-term debt*	
Proceeds from reissue of treasury Stock	84,240
CASH FLOW FROM FINANCING ACTIVITIES	**84,945**
Net cash from continuing operations before taxes	**602,754**
INCOME TAXES	
Cash paid for current tax expense	(281,221)
Change in cash before equity items and disc. ops.	**321,533**
DISCONTINUED OPERATIONS	
Cash outflows from discontinued operations	(12,582)
Total change in cash from discontinued operations	(12,582)
Change in cash before foreign exchange	**308,951**
Effect of foreign exchange	3,209
Change in cash	**312,160**
Beginning cash	861,941
Ending cash	**1,174,101**

* Line items without values left as placeholders

Alternative 2 - Indirect-Method SCF (continued)

Note X - Supplemental cash flow disclosures

The company collected $2,815,950 from customers for the year ended 31 December 2010.

The following table reconciles working capital changes on the cash flow statement versus the changes to the corresponding accounts on the statement of financial position:

Line item	Change per balance Sheet	Foreign Currency	Other remeasurement	M&A	Change per cash flow
Accounts Receivable, Net	$ 394,195	(1,600)	28,055	-	420,650
Inventory	87,628	1,622	(29,000)	-	60,250

-or-

Below are supplemental reconciliations of the Company's significant accounts as in Alternative C from IASB agenda paper 7B/FASB memorandum 70B.

Note Y - Revenues and Billings

	Accounts Receivable	Bad Debt	Customer Advances
Beginning balance 1 January 2010	$ 541,375	$ (13,534)	$ (425,000)
Collections from customers	(2,491,950)	-	(324,000)
Sale of receivables	(8,000)	-	-
Total Cash Changes	(2,499,950)	-	(324,000)
Revenue accrual	2,920,600	-	567,000
Write-offs	(12,960)	12,960	-
Other adjustment - bad debt reserve	-	(23,068)	-
Remeasurement - loss on sale of receivables	(4,987)	-	-
Remeasurement - foreign exchange	1,600	-	-
Ending balance 31 December 2010	945,678	(23,642)	(182,000)

Note Z - Inventory Costs

	Inventory	Inventory Accounts Payable
Beginning balance 1 January 2010	$ 767,102	$ (505,000)
Cash paid for purchases	-	935,544
Total Cash Changes	-	935,544
Accrual - credit purchases	1,043,100	(1,043,100)
Allocation - wages, benefits, depreciation	624,300	-
Reduction from sales	(1,727,650)	-
Remeasurement - Loss on inventory	(29,000)	-
Remeasurement - foreign exchange	1,622	-
Ending balance 31 December 2010	$ 679,474	$ (612,556)

* Line items as placeholders to demonstrate possible reconciling line items

** If this alternative is pursued, a determination as to which accounts are presented would have to be determined. Examples are not intended to be a complete prescribed list.

Appendix B: CFA Institute Cash Flow Survey

See separate file (15 pages)