Project **Financial Statement Presentation**

Topic **Statement of Cash Flows**

Introduction

1. This paper for discussion at the financial statement presentation (FSP) working group (WG) meeting addresses how cash flow information should be included in the financial statements and how that information should be presented.

Staff Draft proposal

2. In the statement of cash flows (SCF), an entity would use a direct method to present cash flows in each of its sections and categories. For example, an entity would present separately the classes of its cash receipts and payments for its operating activities, such as cash collected from customers and cash paid to suppliers to acquire inventory. The disaggregation of cash flows in the SCF would be more limited than the disaggregation in the statement of comprehensive income.

3. An entity would also be required to reconcile operating income to operating cash flows as part of the SCF. This is referred to as an indirect method of presenting operating cash flows.

4. The definitions of operating, investing and financing cash flows are different from the definitions in IAS 7 *Statement of Cash Flows* and Topic 230 Statement of Cash Flows. For example, cash flows related to capital expenditures are currently presented in the investing category. An entity would most likely present those cash flows in the operating category using the proposed definitions. Aligning the definitions across statements and disaggregating

operating cash flows would help users relate information about operating assets and liabilities and operating income and expenses to operating cash receipts and payments.

What we heard during outreach activities

Field visit input (costs and operationality)

5. During field visits with preparer companies, we discussed the level of disaggregation and whether it was feasible to use an indirect-direct method to derive cash flow amounts by adjusting changes on the balance sheet for
   (a) corresponding income and expense items and
   (b) other adjustments that affect the asset or liability balances that are not specific to the cash flow being derived.
6. Field visit companies expressed the following concerns about using the indirect-direct method to derive cash flows:
   (a) The general ledger structure and current processes would still have to undergo changes that would bring about significant costs
   (b) The timing of earnings releases and regulatory filings necessitates a system oriented compilation of the statement (a direct-direct approach), not a manual process
   (c) Discomfort with “backing into” a number that will appear prominently on the face of the financial statements.
   (d) Without a “bottoms – up” accumulation of direct cash flow information, management would not be able to explain the fluctuations period to period to investors
   (e) Auditability and controls over numbers that are the “remainder” of a calculation is not achievable
   (f) There is no way to guarantee that all the adjustments that would be needed to do the calculation could be accounted for (“we don’t know what we don’t know”).
7. Some companies explained that less disaggregation (than what was proposed in the discussion paper) potentially saves costs. However, to derive information about cash flows, modifications would have to be made to the structure of their ledgers. For example, accounts payable may contain payables for both labor and

for materials. To derive separate cash flows for labor and material, an entity would have to accrue those payables separately. This would be costly.

8. Many companies were uncomfortable using a derived approach to prepare the statement of cash flows. This is despite the fact that this method is often employed today when companies present cash paid for property, plant and equipment or interest paid.

9. Field visit companies expressed concern that management wouldn't be able to answer questions about why specific cash flows had increased or decreased if it didn't use transaction level data to compile the amounts presented in the SCF.

10. Companies also questioned whether their auditors would sign off on a number that was a "plug". As noted in paragraphs 24-26, the auditors we spoke with said that they could opine on a derived number as long as there are controls around how an entity determines that number. Some companies said that even though their auditors may be able to get comfortable with derived numbers, they weren't sure their certifying officers (for example, CFO) would be comfortable signing off on the numbers.

11. Some companies also were concerned that in deriving cash flow amounts by adjusting changes in balance sheet accounts, they would not know if **all** of the necessary adjustments had been made. However, companies noted that many of these adjustments (foreign exchange, acquisition adjustments, and reclassifications) are utilized in compiling today's indirect SCF or in management reporting.

12. Based on their concerns, many of the companies thought they would choose to use transaction level data to present information about operating cash inflows and outflows (that is direct-direct method) if the final standard requires a direct method SCF. The costs associated with preparing the SCF using this method would involve significant costs to modify systems throughout the IT structure as well as costs associated with changes to their processes.

13. Some companies thought that modifications to today's indirect method SCF and/or supplemental disclosures of particular types of cash flows would be less

costly than what is proposed in the Staff Draft and would provide beneficial information. For example:

(a) Companies thought they could provide explanatory information about the changes in statement of financial position (SFP) line items used in the indirect method SCF as well as disaggregate those items more fully.

(b) Some of the companies understood why “cash from customers” would be useful; however, others thought it was absolutely not useful.

(c) Most companies thought they could disaggregate

   (i) Payments for capital items (such as property, plant, and equipment or patents);

   (ii) Payments for the settlement of operating finance items (such as cash funding of pension plan or cash paid for leases), or;

   (iii) One-time or important cash flows (such as a large legal settlement).

Views of financial statement users (benefits)

14. All of the non-financial services entity analysts we spoke with believe the reconciliation of operating income to operating cash flows is essential. They do not want the information in the reconciliation to be eliminated under any circumstance.

15. Financial institution analysts stated that they generally do not use the indirect method SCF that is provided today.

16. Many of the analysts we spoke with believe **both** a reconciliation of operating income to operating cash flows as well as detailed information of *some* gross operating cash receipts and payments would be useful.

17. Those who were in favour of the presentation of some gross operating cash receipts and payments said they found it useful in the following ways:

(a) Information about cash from customers would help them evaluate the quality of revenues and thus earnings.

(b) One firm emphasized that accrued and deferred revenue make cash from customers very important, especially in light of some of the pronouncements coming in the future (leases and revenue recognition), which could result in material differences in cash and the reported income/expense.

(c) Most of the analysts we spoke with focus on operating cash flow as a significant metric. They usually build a forecast of operating cash flows using an operating income metric such as earnings before interest taxes depreciation and amortization (EBITDA) (which one firm criticized as a very weak proxy for cash flow) and adjust it for working capital changes. Information about cash flows such as a factoring of receivables or the settlement of a legal obligation would help them better understand what affected cash during the period so that they could normalize this metric.

(d) Many analysts said standardization of or less discretion over the starting point of the reconciliation and what is included in the reconciliation would be helpful, noting that the definition of working capital is inconsistent and they have no idea what is included in 'other'.

(e) The information would inform the questions they ask of management.

(f) The information could send signals about what is happening within the entity when trends are analyzed.

(g) The information would provide the data they attempt to construct on their own using the financial statements and rudimentary rollforwards of key accounts.

18. Some analysts voiced support for a presentation of the direct method SCF. They explained that they spend significant amounts of time extracting information from financial statements in order to produce direct cash flow measures related to receivables, payables, interest, taxes, leases, and pensions to use in their models.

19. A few analysts said they see frequent and significant fluctuations in accounts receivable and payables, and therefore find changes in those accounts in the indirect method SCF much less helpful than direct measures would be. They cited the need for cash from customers or information about the changes in the accounts receivable balance not related to customer collections (such as the impact of foreign exchange on the accounts receivable balance).

20. Many did not view all the lines illustrated in the staff draft as necessary. Instead, they suggested that improvements to the indirect reconciliation plus the information in the analyses of changes would provide information that would be useful in the same way operating cash inflows and outflows would be useful.

21. Most analysts felt that the disaggregation of non-recurring items, capital expenditures and cash flows associated with operating finance liabilities would be the right amount of "direct" operating cash flow items; the rest of the operating cash flows could be presented "indirectly."

22. Most analysts thought that if the indirect method SCF began with operating income (rather than net income), that would be an improvement. Furthermore, they thought that disaggregating net change items in the operating category in the SCF to align with the line items in the SFP (for example, change in accounts receivable, change in other receivables, change in inventory) would be an improvement. Some thought that disaggregating the net change items coupled with information provided by the analyses of changes would make presenting cash inflows and outflows such as cash paid for labor or cash collected from customers less important.

23. The staff spoke with users who follow companies that present a direct method SCF. The staff asked about their perceptions of those companies and the cash flow information they present in their financial statements relative to the other companies they follow. The majority of the users said that:

    (a) They have not assigned the company that presents a direct method SCF a higher multiple than its peers.

    (b) They do not utilize the direct operating cash flow information differently from the indirect operating cash flow information presented by the other companies in that industry.

Other input received during outreach activities

Auditors

24. During our outreach meetings held with the Big 4 public accounting firms several concerns about the direct method SCF raised on behalf of clients were generally consistent with the issues identified during our preparer field visits. The primary issues were as follows:

    (a) The requirement to disclose certain cash figures which are not currently used by management, and which cannot be compiled without significant system and process changes will likely result in the costs outweighing the benefits.

(b) Concern over the lack of precision that may result from using the indirect-direct method and the uncertainty over unexplained variances (plugs). Particularly, auditors thought that the SEC and PCAOB might take regarding unexplained variances that may result from applying the indirect-direct method. The firms also noted that the staff should clarify in the exposure draft the level of expected precision.

25. The firms also addressed their ability to audit the information. The firms noted that they could generally gain audit comfort over direct cash flow data prepared by their clients as long as the controls and processes are reliable and the data is supportable. However, if there are unexplained variances in excess of their materiality thresholds, those amounts will likely have to be posted to a schedule of unadjusted audit differences, which could impact the audit opinion.

26. The firms agreed that certain direct figures would be useful including cash flows related to operating finance liabilities, significant and unusual payments, and cash paid for taxes and interest. Those amounts should be easy to compile using current systems and processes. Some of the firms believed that cash collected from customers would be useful, but cash flows related to by nature operating expenses would not.

Preparers

27. Other preparer meetings echoed similar concerns about the direct method SCF as did the field tests. That is, the information would be costly to prepare and yield little benefit as it is not the way they look at their business.

28. We met with two preparers who present a direct-method SCF disaggregated in accordance with current guidance. One company derives operating cash flows and said that doing so is not costly, however they don’t see a great benefit in providing this information. The other company maintains detailed cash flow information and has built their accounting systems and processes around cash transactions.

Others

29. We met with two small groups of users to evaluate the indirect and direct method of presenting operating cash flows. The two groups were shown indirect method operating cash flow information and asked to analyze what happened

during the period. They were then presented the corresponding direct method operating cash flow information and asked the same questions.

30. The first group acknowledged the information in the direct method presentation as different but the majority were perfectly satisfied with the indirect presentation. The first group expressed that an indirect SCF that starts with operating income or EBITDA would be a better starting point and were happy to analyze changes in asset and liability amounts to understand cash flows.

31. The second group was more in favour of the direct presentation, not because the amounts would be used as a basis of modelling future cash flows, but because presenting cash flows “directly” would inform their questions in a different way than the information in the indirect SCF would.

Field test results and/or feedback

32. The respondents in the Discussion Paper follow-up group did not feel that the changes in the Staff Draft relaxing the requirements proposed for the direct method SCF were an improvement over the requirements in the Discussion Paper. Both the Discussion Paper follow-up group and the private company group of field test participants expressed concern that gathering the information to prepare a direct method SCF would require significant changes to information systems and business processes in order to capture cash flow information.

33. Most respondents in the Discussion Paper follow up and private company field test groups felt that the reconciliation of income or loss from operating activities to net cash flows from operating activities is integral to understanding cash flow information about their company.

Financial service entities

34. Today’s cash flow statement presented by financial service entities is not viewed as useful by most analysts. The reasons given are:

    (a) The categorization results in subtotals that are not meaningful

    (b) Meaningful amounts are netted together

    (c) The focus of users is on the balance sheet rather than the sources and uses of the cash that funds the balance sheet.

35. Users of financial service entity financial statements found aspects of the cash flow information presented in the Staff Draft as interesting and potentially useful. Information highlighted by users as useful as well as information that they do not get today include:

    (a) Cash interest received (as well as cash interest received versus paid)

    (b) Gross payments on loan originations and loan repayments

36. Some users thought some of the items presented in illustrative SCF in the Staff Draft would be useful or interesting; however they weren't necessarily in favour of requiring a direct method SCF for financial service entities.

37. Some financial services analysts would like to see cash interest received, cash interest paid, cash collections of principal, cash collected from sales of loans, and cash from loan originations shown on a gross basis. One institution's financial analysts said that the level of detail shown in the illustrative SCF would be a great addition and would help them analyze banks because items such as those mentioned above would be presented.

38. An insurance analyst was unsure how useful the additional disaggregation of operating receipts and payments would be. He said there were only a few lines that would be of incremental benefit: claims payments, premiums received, loss expense payments, and commissions payments.

Possible alternatives

39. All users agree that the indirect method SCF is an important part of their analysis of non-financial services companies. Responses from users regarding the direct method SCF were mixed. However, users were clear that they did not want to lose any of the "direct" cash flow information they receive today (for example capital expenditures).

40. Some of the users we spoke to think that some of the benefits associated with direct method cash flow information could be delivered in different and more cost beneficial ways. Many users were sensitive to the high costs that entities would incur to provide a direct method SCF.

41. Based on the feedback received, the staff think the boards should explore ways to improve today's indirect method SCF, some of which are included in the staff draft proposals.

42. Improvements to the SCF proposed in the Staff Draft include:

    (a) better categorisation of cash flows based on the activities of the entity;

    (b) a common starting point for the indirect method SCF (operating income) that results in fewer non cash adjustments, and;

    (c) improved comparability across entities due to categorization of cash flows based on the function versus the structure of the underlying asset or liability.

43. In response to user input, there are several additional improvements which could be made to the statement of cash flows that would not involve the direct presentation of operating cash inflows and outflows. Some possible improvements are listed below and explained in the paragraphs that follow:

    (a) Disaggregate the change in SFP accounts presented in the SCF to align with the line items presented on the SFP (paragraph 44).

    (b) Disaggregate gross cash inflows that have explanatory power as to the changes in operating cash flows during the period (paragraph 45).

    (c) Disclose supplemental cash flow amounts that users have expressed interest in, such as *cash from customers* (paragraphs 46 and 47)

    (d) Provide information about the change in an SFP accounts that would assist a user in discerning cash flow amounts (this information would be provided as part of the proposed analyses of changes)

44. Disaggregating each change in SFP line item presented in the SCF to align with amounts on the SFP will increase transparency as to the sources and uses of cash. For example, a user may think that the change in *Accounts Receivables and Other Assets* is primarily driven by collections from customers. However, this may not necessarily be the case as a significant portion of the change may relate to the change in *Other Assets*. This may lead a user to either make a wrong assumption about collections from customers or to make investment decisions without information that separates these two changes.

45. Requiring an entity to disaggregate cash inflows or outflows that explain the sources and uses of operating cash would enhance the information presented in

the cash flow statement. For example, if the *Change in Accounts Receivable and Other Assets* shows a source of $1,000,000 but during the period there is a collection of an insurance settlement of $800,000, presenting the $800,000 as a separate line item “cash from insurance settlement” and reporting the *Change in Accounts Receivable and Other Assets* as $200,000 would help a user understand that:

(a) The $800,000 cash source of operating cash flow may be a non-recurring cash flow

(b) The $200,000 cash source from the change in Accounts *Receivable and Other Assets* may be more closely aligned with improved collections from customers.

46. Individual cash flows (such as the insurance settlement mentioned in paragraph 45) disclosed as a supplement to the cash flow statement (not within the statement itself) could be another alternative to providing information that could be used to understand the cash flows of the entity.

47. Furthermore, a prescribed list of cash flows that users have said would be of particular interest (such as cash from customers) could also be required, though the cost would potentially be something greater than disclosing one time or non-recurring cash flows like an insurance settlement.

Discussion questions—presentation of cash flow information

1. Is there any additional outreach the staff should do concerning the SCF?

2. Which of the improvements to the reconciliation of operating income to operating cash flows described in paragraph 43 should the boards consider before issuing an Exposure Draft?

3. If the boards decide to not require a direct method SCF, should entities currently presenting a direct method SCF be permitted to continue to do so or should there be only one method be permitted?