STAFF PAPER

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IASB Meeting

Project	**Disclosure Initiative**
Paper topic	Principles of Disclosure: issues relating to cash flow statements and related disclosures

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Background

1. We expect to complete the discussion of the contents of a Discussion Paper on the Principles of Disclosure project early in 2015. That project includes a review of the general requirements of IAS 7 *'Statement of Cash Flows'* to identify opportunities for improvement. Preliminary analysis for this review has been undertaken by staff of the UK Financial Reporting Council, who have been working with the Disclosure Initiative team.

2. The paper that follows presents a summary of issues relating to cash flow statements and related disclosures. An earlier version of the paper has been discussed by the FRC's Accounting Council, by EFRAG's Consultative Forum of Standard-Setters and by IFASS: however, the tentative views are those of the author.

Purpose of the paper

3. Whilst suggestions for drafting would be welcome, the principal aim is to obtain views on the direction of travel.

4. Accordingly, although the paper contains 18 tentative views the IASB is not being asked to vote on any of these matters. If the IASB supports the direction this review is taking we will continue to develop the work with a view to bringing a

package of recommendations to the IASB for the cash flow chapter(s) in the Principles of Disclosure Discussion Paper.

Questions for the IASB
Do IASB members have any comments, or concerns, about the general direction of this analysis? Are there any tentative views that you think need more analysis? Are there any matters that you think are missing from the discussion? (Section 5 of the paper identifies areas for potential further development).

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Principles of Disclosure:
Issues relating to cash flow statements and related disclosures

1 Introduction

1.1 The purpose of this paper is to seek the Board's views on some issues relating to the reporting of information about cash flows that might be addressed in that Discussion Paper. To assist that discussion, my tentative views are presented within this paper. For convenience, these views are also listed in Appendix A.

1.2 Appendix B presents an illustrative example derived from that presented in IAS 7 and shows how that example might be re-presented in accordance with the views expressed in this paper.

1.3 This paper does not attempt to deal comprehensively with all the issues that may be raised in the context of cash flow disclosures. Some further issues that might be addressed in the Discussion Paper are noted in Section 5 of this paper. The following should be noted in particular:

- This paper considers the issues in the context of entities whose business activities typically involve the supply of goods and services to customers. Further consideration is required of whether the conclusions should be modified for financial institutions and other business activities that include trading on deep and liquid markets.

- Evidence from outreach suggests that the main categories prescribed by IAS 7—operating, investing and financing—are not always applied consistently in practice, and this impairs the comparability and hence the usefulness of the cash flow statement. This suggests that more prescriptive definitions should be used or additional guidance given.

1.4 There are a couple of important points that have informed the discussion in this paper. As they are pervasive, they will need to be revisited throughout the project as a package of proposals emerges. They are:

- The usefulness of cash flow disclosures is greatly enhanced if they can be related to information reported elsewhere in the financial statements—in other words if the financial statements are cohesive.
- The IASB, like other standard-setters including the FRC, is mindful of the criticism of a proliferation of disclosure requirements, which may lead to excessively detailed financial statements in which the most relevant information may be hard to find.

2 The usefulness of information about cash flow

2.1 To provide direction for this work it is helpful to explore why information about cash flow is useful. The following views have emerged from a review of literature, outreach to investors (involving some thirty participants, including German and Japanese investors), and past discussions with standard-setters.

2.2 IAS 7 notes: *"The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation"*. It is to assist in this evaluation that it requires information about *"the historical changes in cash and cash equivalents"*—in other words an account of where the cash has come from and where it has gone.

2.3 The IASB's Conceptual Framework notes (in paragraph OB20):

Information about a reporting entity's cash flows during a period also helps users to assess the entity's ability to generate future net cash inflows. It indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance.

2.4 The following more specific uses for information about cash are discussed in the following paragraphs:

(i) To derive a measure of performance, such as 'free cash flow'. A performance measure may be useful as an input to valuation (enterprise value can be estimated as the present value of future free cash flow). Performance measures are also useful to users in filtering a population: for example, an investor may wish to identify the companies within a sector that have the most significant growth in a performance measure in order to concentrate further analysis on those companies.

(ii) To assess liquidity—that is to assess whether the entity is likely to generate sufficient cash to meet its liabilities as they fall due. This is more important than merely assessing the risk that the entity is likely to face bankruptcy, for if the entity can generate more cash than is required to meet its commitments, the excess can be used to provide further value for shareholders, either by new investments or by dividends.

(iii) Users are interested in the management of working capital. This assists in an assessment of how efficiently the resources of the entity have been managed. This use of information related to cash flow responds to the stewardship objective of financial statements.

(iv) Users wish to understand the changes in the financing of the entity. For example, users wish to know the extent and nature of changes in borrowing and in investments.

A performance measure?

2.5 Providing a measure of performance is perhaps one of the most obvious potential uses of cash flow information. However, as discussed in the following paragraphs, there are a number of reasons why this may not be its paramount purpose.

2.6 One might suppose that accruals information might provide a better insight into performance than information on cash. It has been cogently observed:

Accruals have long been used to measure the ultimate cash consequences of business activities, and allocations have been used to assign resource costs to periods of resource use. The objective of departing from cash-basis accounting is, paradoxically, to improve the measurement of a firm's cash generating ability. Accruals measure cash consequences, and allocations even out lumpy cash expenditure or commitments.[1]

2.7 The IASB's Conceptual Framework makes a slightly lengthier case for the superiority of accruals information (paragraph OB17):

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.

2.8 Some discussions of the use of free cash flow (FCF) suggest that it should be derived from accruals information. James A Ohlson, for example, says:[2]

Many analysts think that if they want to estimate a company's FCF, they need to look at the cash flow statements; however, the cash flow statements are not needed. The best answer to the problem of how to estimate the current FCF is to define FCF as NOPAT [net operating profit after taxes] *minus the change in the book value of invested capital.*

Stephen H Penman advocates a similar approach.[3]

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1 Thomas H Beechy (1983) *Accounting for Corporate Income Taxes: Conceptual Considerations and Empirical Analysis* Canadian Institute of Chartered Accountants, page 128.

2 *Cash Flow Analysis and Equity Valuation*, reprinted as Chapter 16 of Valuation Techniques: Discounted Cash Flow, Earnings Quality, Measures of Value Added, and Real Options, edited by David T Larrabee and Jason A Voss. Wiley, 2013. Page 354.

3 *Financial Statement Analysis and Security Valuation*, Fifth Edition 2012, Chapter 11.

2.9 This suggests that the cash flow statement is not required to provide a performance measure, such as free cash flow. However, it is clear that cash flow information is valuable by providing an alternative perspective on performance, and in particular by relating the results of operations to cash flow.

2.10 The FASB, in the development of FAS 95 'Statement of Cash Flows' concluded that *'reporting cash flow per share would falsely imply that cash flow, or some component of it, is a possible alternative to earnings per share as a measure of performance'* (paragraph 122). It noted that '*net cash flow from operating activities is not comparable to net income because recovery of capital is not a factor in its calculation, and net cash flow from operating activities includes both returns <u>on</u> and returns <u>of</u> investment'.* FAS 95 therefore prohibits the reporting of an amount of cash flow per share.

2.11 One of the dissenting FASB members (Raymond C Lauver) suggested that, in spite of statements to the contrary, FAS 95 attempts to establish cash flow from operating activities as an alternative performance indicator. He objected in particular to FAS 95's observation that 'Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income'. Some of the consequences of that statement are:

(i) Cash flows from operating activities are after interest and tax; and

(ii) Non-operating items that are included in net income are also included in cash flow from operating activities.

These issues are considered later in this paper.

2.12 In summary:

- accruals information provides superior information on performance than information about cash flows;

- at least in the opinion of some, the best measure of free cash flow can be derived from accruals information;

- cash flow information cannot be considered as a measure of performance as it includes both returns on and returns of investment.

2.13 It is therefore reasonable to be wary of the idea that a main focus of improvements to information about cash flow is to provide a measure of performance. However, information about cash flow can assist users in their understanding of performance as it provides a different perspective on an entity's operating activities. By explaining the relationship between accruals-based performance measures and the entity's cash generation cash flow information provides an insight into the quality of performance. It is also important to be aware that some investors may use metrics derived from cash flow information, and it would seem regrettable if any changes deprived them of information that they consider useful. This issue will be explored with the CMAC at its October meeting.

Liquidity

2.14 The US Securities and Exchange Commission has helpfully pointed out:

Cash flow statements report a company's inflows and outflows of cash. This is important because a company needs to have enough cash on hand to pay its expenses and purchase assets. While an income statement can tell you whether a company made a profit, a cash flow statement can tell you whether the company generated cash.[4]

2.15 Differences between profitability and liquidity may arise because:

(i) Profits are not represented by cash. This may happen, for example, where profits include the upward revaluation of assets, or where revenue is recognised before the customer pays, for example on a long-term contract.

(ii) Profits are struck after deducting non-cash expenses, for example depreciation and share-based remuneration.

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4 Beginners' Guide to Financial Statements http://www.sec.gov/investor/pubs/begfinstmtguide.htm (accessed 30 July 2014)

(ii) Cash generated from profitable trading is reinvested in assets other than cash, perhaps including highly illiquid assets.

2.16 Information on liquidity is reported in the balance sheet (statement of financial position). Because that statement reports the amount of cash and other assets and liabilities, it should assist an evaluation of whether the entity is able to meet its liabilities when they fall due. As comparative amounts are provided it is also possible to assess the extent to which that position has changed in the reporting period.

2.17 However, a cash flow statement can enhance a users' understanding of liquidity and changes in liquidity by:

- focussing attention on the net change in cash and cash equivalents; and
- highlighting the reasons for changes in the cash position, for example whether it is due to cash generated (or consumed) by operations, or raising (or repaying) borrowing and other sources of finance, or from returns received from (acquisitions of) new investment.

2.18 Evidence from outreach confirms that investors see information on liquidity as one of the most important aspects of cash flow information. This may affect their views of the financial risk to which an entity is subject, and the entity's ability to service its debts, or generate cash surpluses, which can be invested or returned to shareholders.

Management of working capital

2.19 Disclosures relating to the cash flow statement also highlight information that assist an assessment of how efficiently the resources of the entity have been managed. Changes in working capital and their relationship to other amounts reported in the period may highlight, for example, whether an increase in accounts receivable is proportionate to an increase in sales—if not, it may be that the entity's ability to collect receivables has deteriorated. Again, evidence from outreach confirms that management of working capital is of interest to investors.

2.20 Information about changes in working capital is, under present practice, frequently reported in the statement of cash flows within a reconciliation of a measure of profit and cash flows. It is therefore appropriate to include a consideration of the requirements governing its presentation within the present project, even though it is not, in itself, information about cash inflows and outflows. (This is one reason that the title of this paper includes a reference to 'related disclosures'.)

Financing

2.21 Closely related to the above is the need for information on changes in the financial structure of the entity. Cash flow information summarises the receipts from and payments in respect of debt and similar obligations. However, such information is incomplete: financing obligations may be incurred for non-cash consideration (as when equipment is acquired on a lease) and may also change due to movements in exchange rate. Thus a complete picture of changes in finance requires a reconciliation of net debt. As IASB is undertaking a current project on this, it is not further explored in this paper.

2.22 There is a wider point that cash flow information may be misleading if non-cash transactions are not disclosed. For example, cash generated from operating activities will not include goods and services that are acquired for share-based payment. Some would suggest that this information should be presented as a separate column adjacent to the cash flow statement. As noted in Section 5 below, a review of requirements for disclosure of non-cash transactions is envisaged to form part of further work on this project.

Tentative views

1 Information about performance is primarily provided by accruals-based financial statements. The purpose of cash flow disclosures is not to present an alternative measure of performance, but they should explain the relationship between accruals-based performance measures and the entity's cash generation.

2 Cash flow disclosures should supplement the information on liquidity given in the statement of financial position. The most satisfactory means of providing that information is by a complete summary of all cash inflows and outflows that explains the changes in cash—that is, a Statement of Cash Flows.

3 Information on changes in working capital is valuable for assisting an assessment of the efficiency of the management of resources.

4 Cash flow disclosures need to be supplemented by other disclosures, as the omission of non-cash transactions may potentially be misleading. Further information, including a reconciliation of net debt, is also necessary to provide a coherent summary of changes in financing.

3 Cash flow from operating activities

3.1 Outreach confirms the importance of reporting cash flow from operating activities. Investors regard this as essential for understanding the financial health of a company and for an assessment of the quality of earnings and hence an assessment of future earnings and cash flow. In this section of the paper, the following issues are discussed:

(i) The reconciliation of cash flow from operating activities and the income statement. More specifically, the question of the measure of profit or loss that should be the starting point of the reconciliation is considered. This leads on to the issue of how ‘operating activities’ should be defined (or described). It is then considered whether the reconciliation should be presented as part of, or as supplementary to, the cash flow statement.

(ii) Three issues are then considered on the content of cash flow from operating activities: (i) property, plant and equipment; (ii) interest and dividends; and (iii) taxation.

Reconciliation and definition

3.2 Under present practice, a reconciliation is generally given between cash flow from operating activities and the income statement.[5] The reconciliation often starts with profit before taxation, and adjustments are made for:

(i) items that do not represent cash flows (e.g. depreciation);

(ii) items that relate to the 'investing' and 'financing' sections rather than operating;

(iii) changes in working capital.

3.3 This reconciliation is generally provided where the indirect method is used. The IASB Staff Draft 'Financial Statement Presentation' of July 2010 proposed that the direct method be required, but that a reconciliation should also be provided. The 2008 Discussion Paper 'Preliminary Views on Financial Statement Presentation' proposed a schedule reconciling the cash flow statement and the statement of comprehensive income line-by-line.

3.4 The evident importance attached to the reconciliation is not surprising. It provides much of the information identified in Section 2 above. Specifically:

- it explains the relationship between a measure of operating performance and cash generation, which assists in an assessment of the quality of earnings and hence an assessment of future earnings and cash flow;

- it provides information on the amount of cash generated by operating activities. This is an especially important for assessing liquidity, as operating activities may be more persistent than other activities; and

- It provides information on changes in working capital, and so assists an assessment of the efficiency with which resources have been managed.

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5 IAS 7 also permits the direct method to be used. It also recognises an alternative method of preparing an indirect method cash flow statement, which adjusts revenue and expenses for the change in inventories and operating receivables and payables.

3.5 Under present practice, the reconciliation may start with any line item in the statement of profit or loss. For example, profit after tax may be used. It is understood that the US Securities and Exchange Commission has challenged the reporting by companies of cash flows starting from anything other than net profit or loss.[6] However, there is some evidence[7] that investors prefer the statement to start from a sub-total on the statement of profit or loss that represents 'operating' income. This has the advantage that it clearly aligns the cash flow from operations and operating income. Because fewer reconciling items are required, the reconciliation will be more transparent and easier to understand. A requirement specifically to reconcile profit or loss from operating activities and net cash flows from operating activities was proposed in the IASB's staff draft 'Financial Statement Presentation' of July 2010.

3.6 It may, however, be difficult to implement such a requirement as there is no requirement to disclose 'profit or loss from operating activities' in IAS 1'Presentation of Financial Statements'. The 1997 version of that standard did include a similar requirement, but that has now been deleted. The Basis for Conclusions to the current version records that the Board did not wish to require disclosure of an undefined term. It also (perhaps curiously) provides guidance to those who elect to make such disclosure (BC55–BC56).

3.7 It is obviously difficult to define 'operating activities' with sufficient precision to be sure that it will be applied completely consistently in practice. However, it would seem to be possible to give sufficient guidance to ensure that it is meaningful. It would also be possible to prescribe additional disclosures to ensure that the user was aware of the definition used in the financial statements. Whilst inconsistent application detracts from comparability, some flexibility in the definition may increase the relevance of what is reported, as management would have some freedom to determine what is regarded as

6 FRC Financial Reporting Lab Project Report: Operating and Investing Cash Flows (November 2012).

7 Financial Reporting Lab *op cit*.

'operating activities'. Investors have told us that management's view on an entity's operating activities is in itself useful information.

3.8 IAS 7 defines operating activities as 'the principal revenue-producing activities of the entity and other activities that are not investing or financing activities' (paragraph 6). One of the consequences of that definition is that 'operating activities' becomes the default category, i.e. it includes anything, irrespective of its nature, that does not meet the definition of the other categories. If operating activities are important, it is possible to feel some discomfort with this. It would seem preferable for only items that are operating to be reported as such—not operating + hard to classify items. A superior approach would be to require non-operating items (and do not fall within one of the other categories) to be reported in an additional, separate, section of the statement of cash flows.

3.9 To meet this aspiration it would be necessary to delete the reference in IAS 7's definition to 'and other activities that are not investing of financing activities' and expand on 'the principal revenue-producing activities' of the entities. It might be explained that 'operating activities' would typically include transactions with customers, employees and suppliers. This would be consistent with the IASB's decision in the context of the Conceptual Framework project that, in developing standards, consideration should be given to an entity's business activities.[8] It should be clear that items should not be excluded from 'operating activities' simply because they are unusual or non-recurring.

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[8] It would also be consistent with the approach to reporting operating profit advocated by Roger Marshall and Andrew Lennard in the paper 'The reporting of income and expense and the choice of measurement bases' presented to the June ASAF meeting.

Tentative views

5 Financial statements should contain a reconciliation between profit or loss from operating activities and cash generated or consumed by operating activities.

6 'Operating activities' should be defined or described, perhaps as including transactions with customers, employees and suppliers. Items should not be excluded from operating activities merely because they are unusual or non-recurring.

7 'Operating activities should not be the default category: items that do not relate to operating activities (or another defined section of the cash flow statement) should be reported separately.

Location of the reconciliation

3.10 Under present practice, the reconciliation is usually presented as the first section of the statement of cash flows. That is, the first line of the cash flow statement is a measure of income (and not cash) that is then adjusted for the items set out in paragraph 3.2 above. These are also not cash flows.

3.11 The FRC's Financial Reporting Lab asked investors (more than 30 individuals from 16 investment organisations) whether they preferred the reconciliation to be shown at the top of the financial statements or in a note.[9] Most preferred it to be presented as part of the cash flow statement. They argued that this was consistent with the importance of the reconciliation, and is easier and less time-consuming to use. They also said it was particularly helpful when viewing reports on electronic media.

3.12 It is, however, doubtful if less sophisticated users find it intuitive or understandable if a cash flow statement starts with an item that is not a cash flow and then adds and subtracts items that are also not cash flows.

3.13 Two dissenting FASB members (Raymond C Lauver and Robert J Swieringa) considered that presenting a reconciliation of net income and net cash flow

[9] FRC Financial Reporting Lab Project Report: *op cit*.

from operating activities within the statement of cash flows rather than in a separate schedule was ‘confusing and counter to the primary purpose of a statement of cash flows’. Another way of expressing this view is to observe that the reconciliation does not <u>provide</u> information on cash flows: rather it <u>explains</u> that information.

3.14 Whilst recognising the views expressed by investors, it is difficult to believe that sophisticated users would suffer a major detriment if the reconciliation appeared in prominent supplementary note to the cash flow statement. Indeed, the FRC’s recent investor outreach suggested that the location of the reconciliation was relatively unimportant.

3.15 The Conceptual Framework states that ‘Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently’ (paragraph QC32). The issue therefore is whether to assume that users will be able to locate a reconciliation presented as supplementary to the cash flow statement, or to assume that users who review a cash flows statement that includes a reconciliation will readily understand which items are cash flows and which are not.

Tentative view

8 The reconciliation between profit or loss from operating activities and cash generated or consumed by operating activities should be presented in a prominent supplementary note to the statement of cash flows rather than as part of the statement itself.

Property, plant and equipment

3.16 Under IAS 7, the purchase of property, plant and equipment is reported as an investing activity. However, because such purchases are required to support operating activities, this requirement appears anomalous. It gives the impression that an entity’s operating activities can be carried out without requiring cash outflows to acquire fixed assets, which is not usually the case if such assets are significant.

3.17 It would be more logical for the purchase of property, plant and equipment to be reported as an operating cash flow, as proposed in the 2010 staff draft

'Financial Statement Presentation'. This would accord with the practice of some users who subtract investing cash flows from cash generated from operations to derive a measure of 'free cash flow'.

3.18 The effect of including the purchase of property, plant and equipment in operating activities is effectively to substitute the current cost of such assets for historical cost depreciation. It might be reasoned that it would equal deprecation on a current replacement cost basis. This is true—but only if it is assumed that the entity's business is not growing (nor shrinking) and that capital expenditure is constant in each period. These are large assumptions that are unlikely to be fulfilled often in practice.

3.19 Perhaps, ideally, a distinction should be made between:

(i) 'replacement' capital expenditure that maintains existing capacity; and

(ii) 'expansion' capital expenditure that expands capacity, or extends the activities of the entity.

It would seem logical, and has been suggested in outreach with investors, that replacement capital expenditure should be reported as a cash outflow from operating activities, whilst that relating to expansion should be reported as an investing activity.

3.20 However, it is apparent that such a distinction may be difficult to apply in practice. Replacement assets are rarely identical to those that are retired, due to changes in technology and business needs. A new production line may provide greater capacity and lower operating costs than the one it replaces. Arbitrariness and subjectivity in allocation would therefore be inevitable. Some may take the view that an inherently arbitrary allocation should not be used in the financial statements, as it lacks the qualitative characteristic of verifiability. They might prefer that the nature of capital expenditure be discussed in the notes, or in a Management Commentary.

3.21 The possible solutions to this issue would be:

(a) to require preparers to make the distinction between 'replacement' and 'expansion' capital expenditure and present them separately in the statement of cash flows as operating and investing activities respectively. A requirement to disclose the basis of allocation could be made; or

(b) to require all capital expenditure to be reported as a cash outflow from operating activities, and encourage separate disclosure of the two classes of capital expenditure. This is the approach adopted in IAS 7 (paragraph 50(c)).

3.22 If separate presentation were required, there would seem to be incentives to classify expenditure as 'expansion'. This would increase the reported cash generated from operating activities, and also increase the amount reported as investment—which might be seen as an indication of management's confidence in future profitability. If this course were adopted, it would therefore seem necessary to set a high hurdle for classifying expenditure as expansion. It might be specified, for example, that:

(i) expenditure should be classified wholly as replacement even if the replacement asset is economically superior to that which it replaces—for example by providing lower operating costs, or greater capacity.

(ii) expenditure on property, plant and equipment should be classified as investing only if it relates to the expansion of the entity's activities to a new line of business.

(iii) the basis for classifying expenditure as investing should be disclosed.

3.23 It is questionable how effective such an approach would be. It would add complexity, and the requirements for the distinction might prompt debate and demands for interpretation. The staff, therefore, is inclined to favour requiring all capital expenditure to be reported as a cash outflow from operating activities, with encouragement of separate disclosure of the two classes of capital expenditure. The Discussion Paper could usefully seek views on this point.

3.24 As was noted a while ago, operating activities may be more persistent than other activities. However, expenditure on property, plant and equipment will often be lumpier than other components of operating activities. For this reason it should be separately disclosed.

3.25 If expenditure on property, plant and equipment is separately disclosed as a component of cash generated from operating activities, it would be natural to disclose an amount of 'cash generated from operating activities before capital expenditure'. In any case, users will be able to derive such a measure. As is discussed below, the tentative staff view is that interest on financing liabilities and tax should both be excluded from cash flow from operating activities. It would seem that a consequence of these would be that 'cash generated from operating activities before capital expenditure' would resemble EBITDA, with cash substituted for earnings.[10] It is not clear whether this supports the tentative staff views.

3.26 An issue related to the reporting of cash flows for the acquisition of property, plant and equipment, arises in the presentation of business combinations. The cash consideration for the acquisition of a business would presumably be reported as a cash outflow from investing activities.[11] However, sometimes there may be little substantive difference between buying a business and purchasing assets. IFRS 3 'Business Combinations' addresses whether a transaction is a business combination or the acquisition of assets and liabilities. (The IASB may well reconsider this part of IFRS 3 as a result of the Post Issuance Review.) It would seem confusing and unnecessary to use a different distinction for the purposes of cash flow information.

3.27 As noted in Section 5, a review of the requirements to present information related to cash flow about business combinations is among the issues that need to be addressed in future work.

Tentative views

9 Cash outflows to acquire property, plant and equipment (as defined in IAS 16) should be reported as a cash outflow from operating activities.

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[10] This assumes that 'earnings' includes only operating items, interest and tax.

[11] A different approach would be to restrict the 'investment' category to cash flows relating to dealing in assets that are held for a financial return. Under this approach, the acquisition of a business would be reported as an operating cash flow. This would be consistent with the reporting of cash flows generated by the acquired business, which would be reported within cash flows from operating activities.

10 The provision of information to assist an assessment of the extent to which expenditure on property, plant and equipment that represents ‘replacement’ and ‘expansion’ should be encouraged.

11 Cash consideration paid to acquire a business (as defined in IFRS 3) should be reported as a cash outflow from investing activities.

Interest and dividends

3.28 IAS 7 requires an entity to disclose separately cash flows from interest and dividends received and paid and classify them consistently within the categories of operating, investing or financing. The flexibility this allows can be expected to lead diversity in practice and hence a loss of comparability.

3.29 Interestingly, the Illustrative Examples that accompany IAS 7 include an amount captioned ‘Cash generated from operations’ that excludes interest and tax paid: these items are then deducted to arrive at a total for ‘Net cash from operating activities’.

3.30 FAS 95 ‘Statement of Cash Flows’ requires all of cash flows of interest received and paid and dividends received to be reported within operating activities—a treatment to which three (of the then seven) FASB members dissented. The options allowed by IAS 7 and the divergence of views among FASB members shows that the classification of such cash flows is a difficult issue.

3.31 The difficulties may be illustrated by considering the example of zero coupon debt. Such debt requires only one cash flow, which is paid on maturity. Therefore in accounting periods while the debt is in issue no cash flows are reported. In the period in which it matures a single cash flow may be split into an amount representing interest, reported as a cash outflow from operating activities, and an amount representing repayment of principal, reported as a cash flow relating to financing activities. At least one writer[12] has commended this approach, and also suggested that the cash flow statement should be

[12] Standard & Poor’s Rating Services *Ratings Direct: The Statement of Cash Flows—Comparing the Incomparable* February 2014

adjusted to report the imputed interest for the periods in which zero coupon debt is in issue.

3.32 A loan may be thought of as simply an exchange in which cash is received on issue, and in return for which cash repayments are promised. The cash repayments may be characterised from a legal perspective as payments of principal or interest and this may be important in some circumstances, such as in the event of default. However, such a characterisation does not seem relevant for the cash flow statement: all cash payments to lenders are simply fulfilment of contractual promises made to the holders of the debt, and should therefore be classified as financing cash outflows.

3.33 It may be questioned whether the concept of interest is relevant for the purposes of reporting cash flow information. The concept of interest is necessary to identify whether an amount represents a return *of* capital or a return *on* capital, which is fundamental to the preparation of accrual information. But it is unnecessary and misleading in the context of cash flow. Putting this another way: for accruals accounting it is necessary to determine whether a cash flow represents a change in net assets or income or expense: this question does not arise in preparing a cash flow statement. Instead the main question that arises is to in what category the cash flow should be presented.

3.34 In the case of zero coupon debt, this analysis would suggest that only one cash outflow is reported in the cash flow statement—and that arises in the period in which the debt matures. That outflow might be described in the cash flow statement as a ‘payment to providers of debt finance’. This is representationally faithful of the actual cash flows relating to the debt. Some consider that it would be informative to separately disclose the amounts that relate to interest and principal.

3.35 Perhaps a more difficult situation is that of the sale of an asset on credit terms that are sufficiently long term that discounting is material. As with zero coupon debt, it is tempting to split the cash flow, with the interest element reported in investing activities and the amount equivalent to the cash price of the goods reported as a cash inflow from operating activities.

3.36 The 2010 Staff Draft proposed a sub-category of the 'operating finance' category, which would have included the liability for goods acquired on long credit terms. However, this sub-category was not used in the cash flow statement *'because the cash flows relating to some liabilities (e.g. pension plans) include both operating and financing elements that are not separable'* (paragraph BC107). Hence all cash outflows for operating finance would be reported in the Business–Operating section of the statement of cash flows.

3.37 It would seem reasonable to distinguish:

(a) the sale of assets on normal credit terms, giving rise to a customer receivable; and

(b) the sale of assets in exchange for a separate financial asset. Such an asset would not normally represent a claim on the purchaser but on a third party and would be classified by the seller as an investment. (It is not intended to suggest that transactions of this kind are common.)

3.38 Using this distinction cash outflows relating to customer receivables (category (a)) would be reported within cash flow from operating activities. Cash flows relating to investments obtained from barter transactions (category (b)) would be reported as relating to investing activities.[13]

3.39 Similarly, when an operating asset is acquired on credit terms, a trade payable would be recognised, and cash payments in respect of that payable would be reported within cash flows from operating activities. In contrast, if the acquisition of an operating asset were financed by debt raised by a third party the following cash flows would be reported:

(i) receipt of loan proceeds—cash inflow within financing activities;

(ii) acquisition of the asset for cash—cash outflow within operating activities; and

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[13] This is a different approach from that advocated by the three FASB members who dissented from the adoption of FAS 95. In their view, the sale of goods for deferred payment should in all cases be regarded as a noncash investing activity, and receipts should be reported as cash inflows from investing.

(iii) payments to loan creditor—cash outflow within financing activities.

3.40 Other items for example, provisions under IAS 37, may be discounted and hence give rise to interest expense in the statement of profit and loss. However, as argued above, 'interest' is not a concept that applies to the statement of cash flows. If the provision relates to operating activities—which is likely to be the case, for example, if it relates to warranty obligations or environmental obligations arising from operations—then cash flows should be reported as relating to operating activities.

3.41 IAS 7 notes that dividends paid may be classified as a component of cash flows from operating activities 'in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows'. This seems somewhat unconvincing. Dividends are clearly paid to providers of capital, and should therefore be reported as financing cash flows, as should other payments (such as those relating to a share repurchase) made to owners in their capacity as owners. Dividends other payments received from investments should be reported as cash flows from investing activities.

Tentative views

12 Cash flows on financing liabilities (including the payment of interest) should be reported in the financing category of the cash flow statement. Cash flows relating to investments (including the receipt of interest) should be reported in the investing category.

13 Cash flows relating to operating activities should be shown within the operating activities section of the cash flow statement, even where the related balance sheet amount is discounted. Examples would include cash received from customers, or paid to suppliers, where transactions have been made on deferred terms, and payments made in respect of operating items for which provisions have been recognised in the statement of financial position.

14 Dividends paid should be shown in financing; dividends received within investing.

Taxation

3.42 IAS 7 (paragraph 35) requires cash flows arising from taxes on income to be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. This is consistent with:

(i) IAS 7's definition of 'operating activities' which, makes it the default category to which all cash flows that do not relate to investing and financing are assigned; and

(ii) the view that cash flow from operating activities should be analogous to earnings, which is, of course, after tax.

The tentative views presented earlier in this paper are inconsistent with both these points.

3.43 As noted above, the Illustrative Examples that accompany IAS 7 exclude taxes paid from 'Cash generated from operations', but include them in 'Net cash from operating activities'.

3.44 The IASB's Staff draft Financial Statement Presentation of July 2010 proposed that all cash flows relating to income taxes should be presented in a separate income tax section in the statement of cash flows. The Basis for Conclusions notes that allocating tax cash flows to separate sections would be complex and arbitrary. This reflects the prevalent practice that tax is generally assessed on a legal entity's total income or expenses rather than its individual activities. It is also frequently the case that the tax paid in a period is based on the transactions of an earlier period: in that circumstance the tax paid on operating activities relates to an earlier period, and not the other cash flows reported in the statement of cash flows.

Tentative view

15 Cash flows relating to income taxes should be presented in a separate income tax section in the statement of cash flows.

4 Direct or indirect method?

4.1 Perhaps the issue that attracts most controversy about the cash flow statement is whether the direct or indirect method should be used. IAS 7 encourages cash flow relating to operating activities to be reported using the direct method, but permits the indirect method as an alternative. Under the direct method the actual amount of a cash flow relating to classes of transactions within operating activities is disclosed—for example, the amount of cash collected from customers. Under the indirect method, the cash flow statement adjusts an amount of profit for non-cash items in order to derive the amount of cash flow from operating activities. Financing and investing activities are reported under the direct method.

4.2 The advantages of the direct method are:

(i) The direct method reports the actual cash flows relating to each activity and line item that is reported.

(ii) A direct method is more intuitive and easier to understand.

(iii) Where a direct method is used, the cash flows relating to operating activities can be disaggregated. Thus, for example, cash received from customers, cash paid to suppliers; and cash paid to employees may be separately reported. This disaggregation can assist users in assessing the amount, timing and uncertainty of future cash flows. Hales and Orpurt[14] review the academic literature and report that it confirms that the components of cash flow obtained by the direct method provide information useful for predicting future operating cash flow and earnings.

4.3 A requirement to use the direct method was proposed in the IASB's Discussion Paper 'Preliminary Views on Financial Statement Presentation' (October 2008) and the Staff Draft 'Financial Statement Presentation' of July 2010. Responses and outreach in connection with these revealed that many

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14 Jeffrey Hales and Steven F Orpurt (2013) *A Review of Academic Research on the Reporting of Cash Flows from Operations* Accounting Horizons, Vol. 27 No.3 pp. 539-578.

disagreed. One of the main concerns expressed was the cost that such a change would impose on preparers of financial statements. It may be, however, that much of the cost would be in making the changes to systems necessary to produce a direct method cash flow statement, and that on-going cost implications would not be great. This would be consistent with some evidence from Australia that entities that previously used the direct method and are now permitted a choice continue to use the direct method.

4.4 Rather than preparing a direct method statement of cash flows from cash records (the 'direct direct method') a direct method cash flows statement can be prepared by adjusting an income statement line item for changes in related assets and liabilities (the 'indirect direct method'). For example, the amount of cash collected from customers can, in a simple case, be found by adjusting turnover by the amount of changes in customer receivables. Preparers are, however, not persuaded that expressly permitting the indirect direct method would significantly reduce costs. There is also some unease about reporting amounts that may be thought to be highly significant and objective if it is the product of a process that requires the use of estimates.

4.5 It is sometimes suggested that investors and other users of financial statements prefer a direct method cash flow statement. However, the evidence is rather equivocal. Outreach carried out by the FRC shows that views are divided: although a significant number, perhaps a small majority, prefer a direct method statement of cash flows there are also many who express a preference for the indirect method. A recent study from the Confederation of Swedish Enterprise, [15] which is based on forty in-depth interviews with experienced capital market actors, concluded:

most interviewees told us that they looked at the actual statement of cash flows, focusing e.g. on changes in working capital. Another common focus area in the cash flow statement was depreciations/amortizations. These findings indicate that experienced users find information that is available in an

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15 Dr Anja Hjelström, Dr Tomas Hjelström, and Dr Ebba Sjögren *Decision Usefulness Explored: An investigation of capital market actors' use of financial reports.* Svenskt Näringsliv (Confederation of Swedish Enterprise), April 2014

indirect cash flow statement to be useful. No interviewee indicated that they would have preferred a direct statement of cash flow.

4.6 Section 3 of this paper proposes that a reconciliation should be provided between profit and cash flow from operating activities. That reconciliation provides much of the important information that is provided by an indirect method statement of cash flows as presented under current practice. This seems to change the question: rather than being whether the direct or indirect method should be required or permitted, the issue becomes: what more detailed information on the components of cash flow from operating activities should be required?

4.7 For example, cash collected from customers is often mentioned as a particularly important item for financial analysis.[16] It would be possible to require disclosure of that amount. If so, it could be emphasised that it could be prepared by the indirect direct method. It is possible that the unease about reporting amounts derived by that method referred to in paragraph 4.4 above would be less severe if it were a supplementary disclosure.

4.8 An alternative approach would be to require additional disclosures that would assist users to derive the amount of components of cash flows from operating activities. For example, if the change in accounts receivable from customers were separately reported it would seem to be possible for users to derive the amount of cash received from customers. But this is true only if the changes in accounts receivable from customers are:

(i) increases due to sales; and

(ii) decreases due to cash collections.

But there may be other changes—for example from the effect of changes in foreign currency rates and impairments. Thus this style of disclosure achieves its objectives only imperfectly. However, it may be judged an

[16] It occurs to me that it would be particularly informative to disclose separately the amount received from customers in respect of (i) sales reported in the current period; and (ii) sales reported in earlier periods; and (iii) sales to be made in a future period. But the cost of providing this information would probably be excessive.

acceptable compromise, as it would presumably be less costly than the alternatives.

4.9 This preliminary paper does not attempt to address which components of cash flow from operating activities should be required. The issue is to be discussed with the Capital Markets Advisory Committee on 16 October.

4.10 It will also be necessary to consider whether any or all of the required components should be within the statement of cash flows or presented as supplementary information. It is, however, clear that the usefulness of the information required can be improved beyond that required by IAS 7, which can be interpreted as not requiring any of the components of changes in working capital to be disclosed.

4.11 There is, of course, nothing to prevent the disclosure of information beyond the minimum requirements of a standard. Thus entities that elect to include a detailed cash flow statement prepared under the direct method in their financial statements would be free to do so, provided the prescribed components were disclosed.

Tentative views

16 It is not necessary for an accounting standard to require or permit a specific method for deriving 'cash flow from operations'. As a reconciliation of profit and cash flow from operating activities is to be required, the indirect method is likely to be widely used in practice: however the direct method should not be prohibited.

17 An accounting standard should identify components of cash flow from operating activities that are particularly significant, and require disclosure either of the amount of such components or of changes in related working capital items.

5 Further issues

5.1 In this section, some further issues in connection with cash flow are noted. I suggest that the Board should discuss these issues at future meetings, but may decide that it is not necessary or appropriate for some of them to be addressed in the Discussion Paper. They are categorised as follows:

A Major issues;

B Review of existing requirements; and

C Issues addressed in the Exposure Draft: Disclosure Initiative: Proposed amendments to IAS 7.

A Major issues

(i) Definition of cash and cash equivalents

It is tempting to suppose that the cash flow statement should report inflows and outflows of cash rather than cash and cash equivalents—as proposed in the IASB's 2008 Discussion Paper. This would have the consequence that investments in short-term instruments would be shown within investing activities. However, purchases and sales of such instruments might be reported net.

(ii) Presentation of net and gross cash flows:

In what circumstances should cash flows be presented gross or permitted (or required) to be presented net?

(iii) Financial institutions

What changes to the proposals are necessary if they are to be applied by, and provide useful information on banks, insurance companies and other financial institutions?

Perhaps more generally, what cash flow information is necessary or useful about business activities that involve the purchase and sale of assets on a deep and liquid market, and thus may readily be converted to cash?

(iv) Components of cash flow from operating activities

This paper has proposed that requirements to disclose components of cash flow from operating activities should be considered. However, it remains to discuss which components should be required, and also whether the requirements should be for specific components (eg cash received from customers), or for changes in the related working capital (eg customer reveivables).

B Review of existing requirements

(v) Definitions of the sections of the cash flow statement

Evidence from outreach suggests that the main categories prescribed by IAS 7—operating, investing and financing—are not always applied consistently in practice, and this impairs the comparability and hence the usefulness of the cash flow statement. This suggests that more prescriptive definitions should be used or additional guidance given.

(vi) Disclosure of non-cash transactions

What improvements are necessary to requirements to disclose non-cash transactions in order to supplement the information disclosed in the statement of cash flow and other related disclosures?

(vii) Disclosures about business combinations

Are the disclosures required by IFRS 3 and other standards, sufficient to portray the impact on cash and other assets and liabilities of business combinations?

(vi) Non-recurring items

Are the requirements of current standards about cash flows relating to non-recurring items satisfactory?

C Issues addressed in the Exposure Draft
Disclosure Initiative: Proposed amendments to IAS 7

The above Exposure Draft will propose:

(i) a reconciliation of carrying amounts relating to financing items;

(ii) restrictions on the use of cash and cash equivalent balances.

Tentative view

18 The IASB should discuss the issues set out in Section 5 of this paper at future meetings, to decide on the contents of the Discussion Paper relating to cash flows.

APPENDIX A

Tentative views presented in this paper

1 *Information about performance is primarily provided by accruals-based financial statements. The purpose of cash flow disclosures is not to present an alternative measure of performance, but they should explain the relationship between accruals-based performance measures and the entity's cash generation.*

2 *Cash flow disclosures should supplement the information on liquidity given in the statement of financial position. The most satisfactory means of providing that information is by a complete summary of all cash inflows and outflows that explains the changes in cash—that is, a Statement of Cash Flows.*

3 *Information on changes in working capital is valuable for assisting an assessment of the efficiency of the management of resources.*

4 *Cash flow disclosures need to be supplemented by other disclosures, as the omission of non-cash transactions may potentially be misleading. Further information, including a reconciliation of net debt, is also necessary to provide a coherent summary of changes in financing.*

5 *Financial statements should contain a reconciliation between profit or loss from operating activities and cash generated or consumed by operating activities.*

6 *'Operating activities' should be defined or described, perhaps as including transactions with customers, employees and suppliers. Items should not be excluded from operating activities merely because they are unusual or non-recurring.*

7 *'Operating activities should not be the default category: items that do not relate to operating activities (or another defined section of the cash flow statement) should be reported separately.*

8 *The reconciliation between profit or loss from operating activities and cash generated or consumed by operating activities should be presented in a prominent supplementary note to the statement of cash flows rather than as part of the statement itself.*

9 *Cash outflows to acquire property, plant and equipment (as defined in IAS 16) should be reported as a cash outflow from operating activities.*

10 *The provision of information to assist an assessment of the extent to which expenditure on property, plant and equipment that represents 'replacement' and 'expansion' should be encouraged.*

11 *Cash consideration paid to acquire a business (as defined in IFRS 3) should be reported as a cash outflow from investing activities.*

12 *Cash flows on financing liabilities (including the payment of interest) should be reported in the financing category of the cash flow statement. Cash flows relating to investments (including the receipt of interest) should be reported in the investing category.*

13 *Cash flows relating to operating activities should be shown within the operating activities section of the cash flow statement, even where the related balance sheet amount is discounted. Examples would include cash received from customers, or paid to suppliers, where transactions have been made on deferred terms, and payments made in respect of operating items for which provisions have been recognised in the statement of financial position.*

14 *Dividends paid should be shown in financing; dividends received within investing.*

15 *Cash flows relating to income taxes should be presented in a separate income tax section in the statement of cash flows.*

16 *It is not necessary for an accounting standard to require or permit a specific method for deriving 'cash flow from operations'. As a reconciliation of profit and cash flow from operating activities is to be required, the indirect method is likely to be widely used in practice: however the direct method should not be prohibited.*

17 *An accounting standard should identify components of cash flow from operating activities that are particularly significant, and require disclosure either of the amount of such components or of changes in related working capital items.*

18 *The IASB should discuss the issues set out in Section 5 of this paper at future meetings, to decide on the contents of the Discussion Paper relating to cash flows.*

Appendix B

IAS 7 Illustrative example A:
Statement of cash flows for an entity other than a financial institution (indirect method)

Cash flow from operating activities		
Profit before taxation	3,350	
Adjustments for:		
Depreciation	450	
Foreign exchange loss	40	
Investment income	(500)	
Interest expense	400	
	3,740	
Increase in trade and other receivables	(500)	
Decrease in inventories	1,050	
Decrease in trade payables	(1,740)	
Cash generated from operations	2,550	
Interest paid	(270)	
Income taxes paid	(900)	
Net cash from operating activities		1,380
Cash flows from investing activities		
Acquisition of subsidiary X net of cash acquired	(550)	
Purchase of property, plant and equipment	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	200	
Net cash used in investing activities		(480)
Cash flows from financing activities		
Proceeds from the sale of share capital	250	
Proceeds from long-term borrowing	250	
Payment of finance lease liabilities	(90)	
Dividends paid	(1,200)	
Net cash used in financing activities		(790)
Net increase in cash and cash equivalents		110
Cash and cash equivalents at beginning of period		120
Cash and cash equivalents at end of period		230

The same example, recast to illustrate the tentative staff views.

Statement of cash flows

Cash flow from operating activities		
Cash generated from operations, before capital expenditure	2,550	
Purchase of property, plant and equipment	(350)	
Proceeds from sale of equipment	20	
Net cash from operating activities		2,220
Cash flows from investing activities		
Acquisition of subsidiary X net of cash acquired	(550)	
Interest received	200	
Dividends received	200	
Net cash used in investing activities		(150)
Cash flows from financing activities		
Proceeds from the sale of share capital	250	
Proceeds from long-term borrowing	250	
Payment of finance lease liabilities	(90)	
Interest paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing activities		(1,060)
Income taxes paid		(900)
Net increase in cash and cash equivalents		110
Cash and cash equivalents at beginning of period		120
Cash and cash equivalents at end of period		230

Reconciliation of
profit and cash flow from operating activities

Profit from operating activities		3,290
Non cash income and expenses:		
Depreciation	450	
		450
Changes in working capital:		
Increase in trade and other receivables	(500)	
Decrease in inventories	1,050	
Decrease in trade payables	(1,740)	
		(1,190)
Cash generated from operations, before capital expenditure		2,550