STAFF PAPER

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IASB Meeting

Project	**Disclosure Initiative**		
Paper topic	Principles of Disclosure: cash flow statements—'cash and cash equivalents' and the management of liquid resources		
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This paper has been prepared for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Background

1. The *Principles of Disclosure* project includes a review of the general requirements of IAS 7 *Statement of Cash Flows* to identify opportunities for improvement. 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. At its October meeting, the IASB discussed a paper that set out tentative staff views that might be raised in the *Principles of Disclosure* Discussion Paper to improve the statement of cash flows. This paper builds on that discussion and discusses 'cash and cash equivalents' and the management of liquid resources. 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 4 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

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recommendations to the IASB for the cash flow chapter(s) in the *Principles of Disclosure* Discussion Paper in Q1 of 2015.

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?

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Principles of Disclosure:
Cash flow statements: 'cash and cash equivalents' and the management of liquid resources

1 Introduction

1.1 At its October meeting, the IASB discussed a paper that set out tentative staff views that might be raised in the Principles of Disclosure Discussion Paper to improve the Statement of Cash Flows. This paper builds on that discussion.

1.2 IAS 7 'Statement of Cash Flows' requires that:

(i) certain assets are treated as 'cash equivalents'. The Statement of Cash Flows focuses on changes in 'cash and cash equivalents' rather than inflows and outflows of cash; and

(ii) some inflows and outflows of cash and cash equivalents may be reported as net rather than gross amounts.

Hence, the purchase of an investment for cash might not be reported as a gross cash outflow for two separate reasons.

1.3 This paper reviews these requirements. It notes that one of the motivations for the focus on cash and cash equivalents is to provide information on an entity's management of its liquidity and considers an alternative way of achieving this.

1.4 Although the issues addressed in this paper are highly significant in the context of financial institutions, this paper does not address these. How and whether the ideas should be modified for financial institutions will be considered at a later stage.

1.5 The purpose of this paper is to seek the Board's views on the direction of travel. To assist that discussion, my tentative views are presented within this paper. For convenience, these are also listed in the Appendix.

1.6 In summary, the views presented in this paper are:

(i) The statement of cash flows should focus on flows of cash, rather than 'cash and cash equivalents' (Section 2);

(ii) The cash flow statement should highlight separately an entity's cash flows relating to liquid resources and the entity's policy for managing such resources (Section 3); and

(iii) Net presentation of cash flows, other than those relating to operating activities, should be permitted only for cash flows relating to financial instruments of the same class (Section 4).

1.7 These views are similar to the requirements of the UK standard FRS 1 (Revised 1996) 'Cash Flow Statements', which seems to have generally worked well in the UK. However, this paper provides a fresh analysis of the issues.

2 'Cash and cash equivalents'

2.1 IAS 7 defines 'cash flows' as inflows and outflows of cash and cash equivalents. In turn:

(i) Cash is defined as 'cash on hand and demand deposits'; and

(ii) Cash equivalents are defined as 'short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value'.

2.2 IAS 7 then notes that:

(i) bank overdrafts which are repayable on demand are included in cash and cash equivalents when they 'form an integral part of an entity's cash management'; and

(ii) an investment 'normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition'.

2.3 It explains that:

Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

2.4 The focus on movements of cash and cash equivalents was reconsidered in the IASB's 2008 Discussion Paper 'Preliminary Views on Financial Statement

Presentation' (at paragraphs 3.14-3.18). It concluded that the concept of 'cash equivalent' should not be retained: the statement of cash flows should show only movements in cash. The Discussion Paper noted that a consequence of this proposal is that cash flows relating to the purchase and sale of investments that would qualify as cash equivalents under IAS 7 would be reported in the cash flow statement. However, it stated that these cash flows would qualify for net presentation under the requirements of IAS 7, for which it proposed no change.

2.5 Essentially the definition of cash equivalents seeks to capture short-term investments that are essentially the same as cash. It may be reasoned that, because of this equivalence, exchanges of cash for such investments are largely irrelevant to users' information needs.

2.6 It is, however, inevitably arbitrary to define which investments are sufficiently close to cash to merit inclusion in 'cash equivalents'. Some subjectivity is inevitable in interpreting 'insignificant risk of changes in value'. There is clearly no strong reason to defend a maturity of three months from acquisition rather than, say two or four months. The IAS 7 requirement also leads to an odd distinction between bonds that now have a short maturity depending on what the maturity was at the time they were acquired: it might be expected that all holdings of the same bond would be treated identically irrespective of the date at which individual holdings of that bond were acquired.[1]

2.6 One of the motivations for the introduction of 'cash and cash equivalents' was to reflect an entity's management of cash and other liquid resources. It is, however, unlikely that all entities manage cash and liquid resources using the same classes of instruments. A standard definition of cash equivalents will not therefore reflect the way in which all entities are managed. In other words, it forces entities to report <u>as if</u> they managed their liquid resources in way that is prescribed by the standard-setter.

2.7 It may also be questioned whether any investments are in fact equivalent to cash. The Discussion Paper noted that cash—and not investments—are required to pay employees and suppliers, and to make distributions to investors. It went on to note:

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[1] The Interpretations Committee decided in 2013 not to add to its agenda a proposal that cash equivalents should be based on the remaining maturity at the balance sheet date rather than that at the date of acquisition.

Although an entity would usually be able to convert cash equivalents to cash quickly to satisfy its need for cash, no short-term investment can have all the characteristics of currency on hand and on-demand deposits. For example, regardless of how near its maturity, a short-term investment is subject to some risk of price change attributable to, for example, sudden changes in the credit environment or the perceived credit quality of the issuer.

2.8 In summary, a focus on 'cash and cash equivalents':

(i) relies on distinctions that are arbitrary and subjective (and hence may be expected to impair comparability between entities);

(ii) cannot faithfully reflect the liquidity management policies of all entities; and

(iii) ignores differences between cash and investments, which in some circumstances are significant.

2.9 Because of these shortcomings, it is recommended that the statement of cash flows should focus on cash, rather than 'cash and cash equivalents'. The guiding principle is that cash should be instruments that can be used to pay expenses and meet financial obligations. The following definition is proposed:

> **Cash comprises cash on hand, and deposits with and advances from banks and similar financial institutions that are repayable on demand.**

The changes from the IAS 7 definition are:

(i) Advances from banks and similar financial institutions that are repayable on demand (i.e. bank overdrafts) are explicitly included in the definition rather than accommodated in supporting explanation; and

(ii) It is explicit that only demand deposits with banks and similar financial institutions qualify as demand deposits.

2.10 It is perhaps helpful to clarify that not all loans that are repayable on demand can qualify as cash. This would exclude, for example, a loan made without stated terms to a related party. The reference to 'similar financial institutions' would include, for example, deposits with building societies.

2.11 Of course, not all cash as defined is available to meet all financial obligations. It may be in the wrong currency or in a geographical location from which it cannot be moved without adverse consequences, such as giving rise to a tax charge. This, however, seems to be a matter for disclosure, rather than exclusion from the definition. Requirements in respect of restricted cash will be discussed at a later stage of this project.

Tentative staff view

1 *The statement of cash flows should report inflows and outflows of cash rather than cash and cash equivalents. The definition of cash should be:*

Cash comprises cash on hand, and deposits with and advances from banks and similar financial institutions that are repayable on demand.

3 Management of liquid resources

3.1 The discussion in Section 2 rejected the notion of cash and cash equivalents on the grounds that it did not provide meaningful insight into an entity's management of liquid resources. Providing such an insight is, however, clearly valuable: indeed as suggested in the October paper, providing information that assisted in an assessment of liquidity was one of the main objectives of the cash flow statement.

3.2 It would therefore be valuable if the statement of cash flows contained a section that was devoted to the management of liquid resources. This would highlight the amount of such resources and changes in them. This could be achieved either by sub-dividing the section on investment activities, or by introducing a new separate section of the statement of cash flows specifically for management of liquid resources.

3.3 Implementing such an approach would require consideration of which assets should be included as 'liquid resources'. However, as noted above, liquidity management policies vary widely between entities, and no accounting standard will therefore reflect the way in which all entities are managed. Allowing some discretion in which assets are regarded as 'liquid resources' would allow cash flow information to be consistent with policies for liquidity management, and would assist users in making a critical assessment of these policies. It would require some disclosures.

3.4 The main distinguishing feature of assets that can reasonably regarded as 'liquid resources' is that they should be liquid—that is, readily convertible into cash. It would seem that where an asset is traded on an active market (to which the entity has access), it would be readily convertible into cash. As a practical expedient, short-term deposits with banks and similar financial institutions might be regarded as readily convertible into cash.

3.5 The notion of 'readily convertible into cash' forms part of the definition of cash equivalents in IAS 7, as noted in paragraph 2.1 above. That definition also requires that cash equivalents be 'subject to an insignificant risk of changes in value'. The basis for this seems to be that holding investments for the management of liquid resources is incompatible with accepting an exposure to the risk of price changes. Putting this another way, if an entity holds assets that expose it to price changes it should be regarded as engaging in investing activities rather than managing liquid resources.

3.6 It is, however, questionable whether such a restriction is necessary or appropriate. Management of liquid resources will inevitably require consideration of a number of objectives, including judgements as to what risks should be accepted at what price. A restriction on the risks that might be accepted on investment of liquid resources would be arbitrary. Whilst it is important that financial statements provide an understanding of what risk of price changes are inherent in an entity's activities, undertaking a transaction that exposes the entity to price risk may be consistent with an entity's policy for management of liquid resources.

3.7 Disclosures necessary for management of liquid resources include:

(i) the entity's policy for the management of liquid resources; and

(ii) the assets that are regarded as liquid resources, and changes in them. It should be possible to reconcile changes in such assets with amounts shown in the statement of financial position. This could be achieved by reference to the classes of financial instruments identified in accordance with paragraph 6 of IFRS 7 'Financial Instruments: Disclosures'.

3.8 These disclosures could be combined with those required by IFRS 7, which requires a description of how an entity manages the liquidity risk arising from the maturity of financial liabilities. However, the objective of the disclosures proposed in paragraph 3.7 above is different as it focuses on what the entity does with those liquid resources which it has, rather than what steps it has taken to deal with a possible future shortfall in liquidity on the maturity of financial liabilities.

Tentative staff views

2 The statement of cash flows should include a section that includes cash flows relating to the management of liquid resources. Liquid resources should be limited to assets that are readily convertible into cash, but should otherwise not be restrictively defined.

3 Entities should be required to disclose their policy for the management of liquid resources, and the classes of instruments that are treated as such.

4 Gross or net cash flows?

4.1 As noted in paragraph 2.4 above, the 2008 Discussion Paper proposed, consistently with the discussion in Section 2 above, that the notion of 'cash equivalents' should not be retained, and reasoned that cash flows relating to the purchase and sale of investments that would qualify as cash equivalents under IAS 7 would qualify for net presentation under the requirements of IAS 7, for which it proposed no change.

4.2 FAS 95 'Statement of Cash Flows', which in many respects closely resembles IAS 7, states "Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments." (paragraph 11, Codification 230-10-45-7). However, both FAS 95 and IAS 7 permit some cash flows to be reported net.

4.3 Where the indirect method is used to prepare the operating activities section of the cash flow statement, only net cash flows are presented.[2] Thus the question of whether cash flows should be presented net or gross is mainly relevant for the investing and financing sections of the statement of cash flows.

4.3 The requirements of IAS 7 for presenting cash flows net include some provisions that are mainly relevant to financial institutions, and will be considered in that context. The requirement that is relevant for present purposes is that the following cash flows may be presented net:

"cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short."

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2 The tentative staff views set out in the October IASB paper suggested that cash flows from operating activities should be disclosed, and reconciled to profit from operating activities. It was not proposed to require the use of the direct method, although requirements for disclosure of some components of cash flows from operating activities should be considered.

4.4 This is a rather odd requirement. The reference to short maturities seems to restrict it to debt instruments, although this is not explicitly stated. The notions of 'quick turnover'; 'large amounts' and 'short maturities' are rather vague. That said, it has been in place for some time and, so far as staff is aware, has not given rise to significant difficulty of interpretation or troublesome diversity in practice. If that is right, it suggests that the wisest course might be to make no change.

4.5 A further consideration is whether the requirements are on point. The underlying thought seems to be cash flows relating to short-term investments and loans are not relevant. This is suggested by the Basis for Conclusions of FAS 95, which states, in part:

For very short-term investments, loans, and debt, relatively insignificant differences in the maturities of items may result in large differences in gross cash flows between enterprises or between periods that are not particularly meaningful. For example, an enterprise that issues seven-day commercial paper and rolls it over every week would report financing cash inflows and outflows four times those of an enterprise that issues one-month paper. While all gross cash flows are potentially relevant, the large reported differences in situations such as that described may not be sufficiently meaningful to require reporting of gross cash flows. The Board therefore decided to permit cash flows stemming from all investments, loans, and debt with original maturities of three months or less to be reported net. (paragraph 79)

4.6 It may be noted that the conclusion in the last sentence of the quotation is broader than that justified by the preceding example. The example is of rollover of a commercial paper programme where each rollover would typically be on the same terms, i.e. those established by the programme, but the conclusion embraces all short maturity investments and loans.

4.7 However, the example seems convincing that netting is appropriate for transactions that are essentially the rollover or reissue of essentially the same investment. And once that is acknowledged it is difficult to know where to stop. For example, there seems little relevance in reporting gross cash flows where, the proceeds received on maturity of an investment in commercial paper issued by a high quality corporate are invested in essentially similar commercial paper issued by a different corporate. On the other hand, it would seem relevant to report the cash flows relating to the sale and purchase of investments of different classes. As with the disclosure of liquid resources, the degree of aggregation could correspond to classes of financial instruments identified in accordance with paragraph 6 of IFRS 7. This would not in itself secure disclosure where investments are replaced by investments of the same class but on substantially different terms. However, a more onerous requirement would run the risk of requiring disclosure that might not often be particularly relevant. And, of course, entities are required to provide additional disclosures where the specific requirements in IFRSs are insufficient to enable users to understand the impact of particular transactions.

Tentative staff view

4 Net presentation of cash flows (other than those in respect of operating activities) should be permitted only for cash flows relating to financial instruments that are of the same class.

APPENDIX

Tentative views presented in this paper

1 *The statement of cash flows should report inflows and outflows of cash rather than cash and cash equivalents. The definition of cash should be:*

Cash comprises cash on hand, and deposits with and advances from banks and similar financial institutions that are repayable on demand.

2 *The statement of cash flows should include a section that includes cash flows relating to the management of liquid resources. Liquid resources should be limited to assets that are readily convertible into cash, but should otherwise not be restrictively defined.*

3 *Entities should be required to disclose their policy for the management of liquid resources, and the classes of instruments that are treated as such.*

4 *Net presentation of cash flows (other than those in respect of operating activities) should be permitted only for cash flows relating to financial instruments that are of the same class.*