STAFF PAPER

6 November 2014

Prepared for the Global Preparers Forum Meeting

Project	Principles of disclosure		
Paper topic	Disclosures of cash flow information		
CONTACT(S)	Andrew Lennard	a.lennard@frc.org.uk	+44 (0)20 7492 2430
	Kristy Robinson	krobinson@ifrs.org	+44 (0)20 7246 6933

Introduction

1. The purpose of this paper is to seek the GPF member's views on issues relating to the reporting of information about cash flows that might be addressed by the IASB in its Discussion Paper on the *Principles of Disclosure* project.

2. An earlier version of the paper which summarised overall issues relating to cash flow statements and related disclosures, has been discussed by the FRC's Accounting Council, by EFRAG's Consultative Forum of Standard-Setters and by IFASS as well as with the IASB at its meeting in October 2014 (**Agenda Paper 11A(c)**): however, the tentative views presented here are those of the authors.

Feedback sought

3. We are seeking feedback on whether the IASB should require the disclosure of key components of cash flow from operating activities. We would also seek to establish the benefits of such disclosure as well as costs of requiring such disclosure.

Background

4. The IASB is working towards a Discussion Paper on the Principles of Disclosure project, and aims to complete its discussions 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.

5. The IASB has not made any decisions at this stage.[1]

6. A central feature of past discussions about the statement of cash flows is whether the direct or indirect method should be required or permitted for cash flows from operating activities. 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.

7. 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: some academic evidence confirms that the components of cash flow obtained by the direct

[1] The IASB had initial discussions about cash flow disclosures at its October 2014 meeting. For more information please see Agenda Paper 11A(c) http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/October/AP11Ac-DI.pdf.

method provide information useful for predicting future operating cash flow and earnings

8. Previous consultations by the IASB show significant opposition to the introduction of a requirement to use the direct method. One of the main concerns is that the cost that it 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.

9. Staff wish to refocus the debate, by concentrating on what information should be required to be disclosed, rather than on the method by which that information should be produced. They wish to explore an approach under which:

   (i) There would be a requirement (as at present) to disclose cash flows from operating activities. This could be prepared by either the direct or indirect method.

   (ii) The amount of cash flows from operating activities would be reconciled to a line item in the statement of profit or loss. That reconciliation, which is generally provided under present practice where the indirect method is used, would highlight changes in working capital. The reconciliation would be required in all cases, not only where the indirect method is used.

10. The approach would not prevent an entity that wished to provide a detailed direct method cash flow statement from doing so. However, it is to be expected that, as under present practice, a large number of entities will choose to use the indirect method. It therefore seems necessary to consider whether it would be appropriate to require any of the components of cash flow from operating activities to be disclosed. In developing proposals for any such disclosure requirements, it is clearly necessary to consider both the benefit to users of the information and the costs of providing it. The benefits and the costs may vary depending on both what information is to be provided, and the method by which disclosure is to be made. These questions are, of course, inter-related but for convenience they are addressed separately below.

11. The benefits of disclosures will be discussed by the IASB's Capital Markets Advisory Committee at its meeting on 16 October. GPF members may be able to contribute further to this, based on their experience of talking to investors, and may also assist us in understanding the nature of the costs, and how they might be reduced.

What information should be required?

12. In principle, 'Cash flows from operating activities' can be analysed into a large number of components. However, for practical purposes, it would seem not be sensible to require greater analysis of cash flow from operations than that usually presented for the statement of profit or loss. Components could be identified by either nature or function.

13. Without wishing to restrict the GPF's discussion, some potential candidates for disclosure, already mentioned above, are:

    (a) cash received from customers;

    (b) cash paid to suppliers; and

    (c) cash paid to employees.

    There are, of course, many others.

14. Cash received from customers is fairly frequently mentioned by investors as a useful disclosure, presumably because it is helpful to compare it with the revenue for the period.

15. Although interest, dividends and tax may be reported within cash flows from operating activities under current requirements, they would not be under the approach being explored by the staff.

Methods of disclosure

16. There are a number of ways that might be considered to reduce the cost of meeting a requirement to disclose components of cash flow from operating activities.

Explicitly permit the 'indirect direct method'

17. The amount of a component can be obtained directly from cash records maintained for the purpose (a 'direct direct method'), or alternatively by adjusting accruals information 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. It would be possible for an accounting standard to make clear that use of the 'indirect direct method' was acceptable.

Disclosure of components of working capital

18. Rather than requiring disclosure of the amount of a component itself, an alternative approach would be to require disclosures that would assist users to derive the amount of components of cash flows from operating activities,. For example, it is possible to estimate the amount of cash collected from customers by adjusting sales for accounts receivable. But this will not provide a reliable estimate if 'accounts receivable' include receivables other than those from customers. So separate disclosure of accounts receivable from customers might be useful.

19. Even so, the estimate would still have to rely on assumptions as to the causes of the change in the amount of accounts receivable from customers. A simple assumption would be that the only changes are:

    (a) increases due to sales; and

    (b) decreases due to cash collections.

20. But there may be other changes—for example from the effect of changes in foreign currency rates and impairments. Separate disclosure of the amount of the change that relates to such non-cash changes might therefore be considered.

Location of the disclosure

21. Components of cash flow from operating activities could be required to be disclosed either as line items within the statement of cash flows. Alternatively, it could be permitted to disclose them as a note to the statement of cash flows.

Previous IASB consultations have revealed some unease about requirements to report amounts, such as cash collected from customers, that may be thought to be highly significant and objective if it is the product of a process that requires the use of estimates. It is possible that this unease would be less if the disclosure were permitted to be made in a note, rather than in the statement of cash flows itself.

Questions for members of the GPF

1. What components of cash flow from operating activities should be required to be disclosed, because they provide useful information?

2. What would be the main costs of requiring such disclosure?

3. To what extent would it be helpful to preparers:

   (a) to make clear that the use of the 'indirect direct method' is permissible?

   (b) to require greater detail of components of working capital and changes in them, rather than the components themselves?

   (c) to permit disclosure of components in a note to the statement of cash flows, rather than in the statement of cash flows itself?