Contact: Andrew Lennard a.lennard@frc.org.uk

Issues relating to cash flow statements and related disclosures

1 Introduction

1.1 One part of the IASB's project on 'Principles of Disclosure" is to review the requirements of IAS 7 *Statement of Cash Flows* to identify possible improvements. Staff of the UK's Financial Reporting Council is undertaking this part of the project. In part, the project is motivated by observations from investors that they attach great importance to information about cash flows, yet find it difficult or impossible to derive the information that they find most useful from today's financial statements. It is planned that IASB's deliberations on the content of a Discussion Paper will be completed by the end of this year.

1.2 There are two issues that we particularly wish to discuss with CMAC in this meeting:

(i) the role of the statement of cash flows in their analysis; and

(ii) information requirements regarding disclosure of components of cash flow from operating activities.

These are discussed in Sections 2 and 3 of this paper. The analysis in these sections is based on a review of literature, outreach to investors and past discussions with standard-setters.

1.3 Additional background is given in AP6A[1] , which reviews these and some other issues relating to cash flow statements and disclosures. We are developing that paper for the IASB's October Board meeting, which will be the

[1] AP6A is a copy of the International Forum of Accounting Standard Setters (IFASS) paper entitled 'Issues relating to cash flow statements and related disclosures'. This paper was discussed at the London IFASS meeting the week of 29 September 2014.

first discussion by the IASB of this part of the project: the IASB has not taken any decisions on the issues raised in this paper.

1.4 If CMAC members have comments on other issues discussed in this paper or AP6A that cannot be raised due to time constraints, we would be grateful to receive them outside of the meeting, for example, by e-mail.

1.5 There are particular concerns with the requirements for cash flow statements for banks, insurance companies and similar businesses. These will be addressed in a later part of the project. Therefore we would like to focus the discussion on non-financial companies.

2 The role of the statement of cash flows[2]

2.1 Some may consider that one of the main uses of the cash flow statement is to provide a measure of performance, analogous to earnings per share. One measure that is often cited is 'free cash flow'. It is sometimes suggested that cash flow measures are superior to accruals-based measures (for example, for use in enterprise valuation models), as the latter are the product of accounting conventions, such as depreciation, that may be applied opportunistically. This would imply that one of the main objectives of the project on cash flow statements should be to provide a useful performance measure.

2.2 The drawbacks of such an approach objective include:

(i) Cash flows may be volatile: accruals accounting assigns uneven inflows and outflows to the period in which they are earned or incurred;

(ii) A cash flow statement does not include non-cash transactions, such as the acquisition of assets under leases and goods and services acquired in exchange for shares. Whilst it might be possible to propose modifying the cash flow statement to include such transactions, that would leave the objective of the cash flow statement unclear. It would also be difficult to determine which non-cash transactions should be included and which should not.

[2] See also AP6A, Section 2

(iii) There are many variants of 'free cash flow'. It would probably be difficult to obtain agreement on what is the single measure that should be prescribed by an accounting standard. It would seem likely that no single measure would be the best for all purposes.

2.3 The IASB's *Conceptual Framework for Financial Report*ing describes the usefulness of the cash flow information as follows:

Information about a reporting entity's cash flows during a period…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. (paragraph OB20)

2.4 This suggests a focus on inflows and outflows of cash. A cash flow statement can supplement the information on liquidity provided by the statement of financial position, by providing a comprehensive account of movements in cash (or, perhaps, 'cash and cash equivalents').

2.5 However, such a statement alone will not satisfy the reasonable expectations of users of financial statements. In particular, it will not explain the relationship between cash generated by operating activities and the performance reported in the statement of profit or loss. This is one of the purposes of a reconciliation between profit or loss and cash generated by operating activities. The insight into how profits are converted to cash may be expected to be useful in assessing the quality of earnings.

2.6 Such a reconciliation also highlights changes in working capital (inventory, receivables, payables etc). This can assist an assessment of the efficiency with which such resources have been managed.

2.7 This reconciliation is generally provided where an indirect method cash flow statement is presented, but is not presently required where the direct method is used. There would seem to be a strong case for requiring it to be presented in all cases.

2.8 It was suggested above that non-cash transactions should not be included in the statement of cash flows. However, supplementary disclosure of such transactions would be helpful. For example, it would be useful to highlight that the cash outlays for property, plant and equipment do not include the acquisition of assets on leases. Some would suggest that such disclosures might be given by adding a column for non-cash transactions to the cash flow statement.

2.9 It is also helpful for the cash flow statement to be supplemented by a reconciliation of liabilities from financing activities. This is the subject of a separate IASB project, for which an Exposure Draft is targeted before the end of the year.

2.10 The above discussion suggests:

(i) The principal purpose of the cash flow statement should be to provide information on cash inflows and inflows, in order to assist in the assessment of liquidity, rather than to provide a measure of performance, such as 'free cash flow'.[3]

(ii) A reconciliation of cash generated from operating activities and profit or loss should be required in all cases. This will assist in the assessment of the quality of earnings and of the efficiency with which working capital is managed.

(iii) Supplementary disclosure of non-cash transactions should be required.

2.11 Even if the cash flow statement is not to be framed as the derivation of a measure of performance, it would seem important to ensure that it, taken together with related disclosures, provides the information that is needed in order to derive widely-used metrics.

---

[3] However, one of the proposals set out in AP6A (at paragraphs 3.16ff) is that cash outflows to acquire property, plant and equipment for use in operations should be reported within 'cash flows from operating activities' rather than as 'investing'. The result would be that 'cash flows from operating activities' would correspond to one of the more widely quoted definitions of 'free cash flow'.

Questions for CMAC members	
(i)	Do you agree with the suggestions in paragraph 2.10 above?
(ii)	Do you frequently use cash flow measures as a performance metric? If so, what information do you need in order to derive those measures?

3 Disclosure of components of cash flows from operating activities[4]

3.1 One of the most controversial aspects of the statement of cash flows is whether the direct method or the indirect method should be required or permitted to derive the cash flows from operating activities.

3.2 The IASB's previous consultations have shown considerable opposition from preparers of financial statements to a requirement to use the direct method from preparers on grounds of cost. Some users of financial statements prefer the direct method. Other users prefer the indirect method, presumably because they value the reconciliation of cash flows from operating activities to profit or loss. It has been suggested above that such a reconciliation should be required in all cases.

3.3 The main distinction between the direct and indirect method cash flow statement is that, if a direct method is used, information can be provided on all the components of cash flows from operating activities, for example:

- cash received from customers
- cash paid to employees
- cash paid to suppliers.

3.4 Such disaggregation would seem to be useful, for the same reasons as it is helpful to disclose separately revenue and cost of sales: each may provide a basis for an assessment of future amounts, but they may be subject to different economic drivers. Hence a projection of gross profit may be more robust if revenues and cost of sales are projected separately, rather than

[4] See additional discussions in AP6A, Section 4

simply gross profit. In the same way, a projection of the components of cash flows from operating activities may be more reliable than a projection of the aggregate amount.

3.5 Accounting standards typically address what information is required to be disclosed in financial statements rather than specify the mechanics of how that information is to be prepared. The most important question therefore is whether an accounting standard should require certain components of cash flow from operating activities to be disclosed. Adopting such an approach may be more cost-effective than requiring a direct method cash flow statement to be used in all cases. Of course, those entities that choose to exceed the requirements of the accounting standard by presenting a detailed direct method cash flow statement would be free to do so.

3.6 It would be useful to hear CMAC's views as to which components of cash flows from operating activities are most useful to investors. Although the value of information about cash received from customers is often mentioned, there seems to be much less demand for other components of cash flows from operating activities.

3.7 The cost of any proposals could perhaps be reduced if, rather than requiring disclosure of the components, disclosures that would assist users to derive the amount of some components were required. These disclosures would take the form of changes in the components of working capital at a granular level.

3.8 For example, if the change in accounts receivable from customers were required to be 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 acceptable compromise, as it would presumably be less costly than the alternatives.

Questions for CMAC members

(i) Would the disclosure of cash collected from customers be valuable?

(ii) What other components of cash from operating activities would be useful?

(iii) Would the disclosure of changes in working capital items (such as accounts receivable from customers) be acceptable?