# STAFF PAPER

September 2014

IASB Meeting

| Project | Disclosure Initiative | | |
|---|---|---|---|
| **Paper topic** | **Amendments to IAS 7 – Disclosure about restrictions on cash and cash equivalents** | | |
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## Objective

1. The objective of this paper is for the IASB to conclude its discussions on whether the proposed amendments to IAS 7 *Statement of Cash Flows* should include amendments to disclosures about cash and cash equivalents.

## Staff recommendation

2. We recommend that the IASB consider improving disclosures about cash and cash equivalents as part of the Disclosure Initiative: Principles of Disclosure research project, instead of as part of the proposed amendments to IAS 7.

## Background

3. The IASB has discussed whether it should improve disclosures regarding cash and cash equivalents on several occasions:

   (a) at its meeting in October 2013 (Agenda Paper 8A) several IASB members mentioned the concern that investors had with identifying cash and cash equivalents that might not be available to settle the debt (as is implied by

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deducting cash and cash equivalents when reporting a net debt reconciliation).

(b) at its meeting in March 2014 (Agenda Paper 11C) the IASB discussed the findings from the investor survey undertaken by staff earlier this year. The survey asked questions about disclosures related to cash and cash equivalents. Respondents to the survey, who identified that they had encountered situations in which there are cash restrictions, answered that they would like improved disclosures about cash and cash equivalents.

(c) also at its meeting in March 2014 the IASB noted that the Capital Markets Advisory Committee, when discussing the net debt reconciliation, had identified that investors need to understand:

   (i) what cash is immediately available for the repayment of debt;

   (ii) the restrictions over cash and/or the costs associated with repatriation of cash when there are foreign exchange controls or tax implications; and

   (iii) what cash is held for regulatory purposes and thereby not immediately available to repay debt.

(d) the staff recommendation in March 2014 was to undertake further research to understand investors' needs regarding the disclosures about cash and cash equivalents as part of the Disclosure Initiative: Principles of Disclosure research project. The IASB, however, asked that the staff consider whether short-term disclosure improvements to IAS 7 regarding cash and cash equivalents could be developed.

(e) in July 2014 (Agenda Paper 11C) the staff proposed an amendment to IAS 7 to include disclosures of the costs that would be incurred if cash or cash equivalents were remitted as earnings to a parent entity. The IASB did not consider that the objective of the proposed disclosure was clear and asked the staff to perform outreach with preparers.

## Definition of the problem

4. As requested, the staff have reached out to the Global Preparers Forum (GPF). The response from the GPF is discussed later in this paper. As part of its response, the GPF noted that:

   (a) it is important that the objective of any proposed disclosure is clear; and

   (b) there is not necessarily a link between cash and cash equivalents and the amount of profits that are available for distribution.

5. In view of the feedback from both the IASB and the GPF, regarding the objective of any proposed disclosure we have considered the reason (objective) for the information request from investors.

6. As part of an investor's assessment of an entity's financial strengths and weaknesses, investors will often deduct cash and cash equivalents from an entity's debt. This net position helps the investor to assess a reporting entity's liquidity. Investors would like more information about cash and cash equivalents, because there is a concern that cash and cash equivalents may not be available to settle debt or be used for another purpose either because there is some form of economic restriction in place (for example the cash and debt are in different jurisdictions and using the cash to settle debt would trigger a tax) or there is a legal or contractual restriction on the ability of the entity to transfer the cash.

7. We think that the information that is being requested by investors focuses on cash and cash equivalent balances – not retained earnings. The confusion between cash and cash equivalent balances and retained earnings arises because recent press articles have discussed the decision by some entities not to make a distribution from an overseas subsidiary (and therefore retain the cash in the overseas subsidiary) and instead seek alternative sources of financing. In making this financing decision, entities are comparing the cost of making a distribution from a subsidiary, including any tax charge that may arise, with the cost of an alternative source of finance. The cost of the alternative source finance will be net of earnings on the cash and cash equivalent balances held by the subsidiary.

8. Investors are seeking information as part of their assessment of an entity's liquidity position that enables them to understand an entity's financing structure, including whether cash is freely transferrable within the entity (that is within the group). We do not think that investors' concern is solely linked to the settlement of debt but to the ability to use the cash where and when it is required within the group.

9. In essence, we think the reason that investors are requesting more information about cash and cash equivalents is similar to the concern of those IASB members who questioned the appropriateness of deducting cash and cash equivalents from debt—a concern that the cash and cash equivalents might not actually be able to use the cash where and when it is required within the group.

## Existing disclosures about cash and cash equivalent balances

10. The staff have previously discussed with the IASB disclosures in current Standards that are related to disclosures about cash and cash equivalent balances (see Appendix 1 of this paper). As noted at the IASB meeting in March 2014, although disclosures in current Standards are related, they do not specifically address the request from investors.

11. At the IASB meeting in July 2014 the staff were asked to consider if there is a relationship between the requests from investors and the disclosures required by IAS 12 *Income Tax*es.

12. Paragraph 38 of IAS 12 notes that temporary differences arise when the carrying amount of investments becomes different from the tax base, for example, undistributed profits, impairment of investments and changes in foreign exchange rates. Paragraph 39 of IAS 12 states:

> An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:

> (a) the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and
>
> (b) it is probable that the temporary difference will not reverse in the foreseeable future.

13. However paragraph 40 of IAS 12 states:

> … when the parent has determined that those profits will not be distributed in the foreseeable future the parent does not recognise a deferred tax liability …

14. Paragraph 81(f) of IAS 12 requires disclosure on such `temporary differences':

> 81 The following shall also be disclosed separately:
>
> …
>
> (f) the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint arrangements, for which deferred tax liabilities have not been recognised (see paragraph 39);

15. In response to the information request, the GPF noted that it could accept that IAS 7 makes a specific reference to the disclosure requirement in paragraph 81(f) IAS 12. However, the staff is concerned (given the view of the IASB in July 2014) that referencing the disclosures in IAS 7 and IAS 12 could create confusion as to whether we are seeking disclosures about cash and cash equivalents or retained earnings as discussed above.

16. On balance, we do not think that the IAS 12 disclosures will necessarily respond to the request from investors because:

    (a) the temporary difference for which deferred tax liabilities have not been recognised may not arise from unremitted earnings; and

    (b) there is a possibility if reference is made between IAS 7 and IAS 12 of creating confusion between cash and cash equivalent balances and retained earnings.

17. We also do not consider that paragraph 82A of IAS 12 applies because the concern identified by investors is related to cash and cash equivalents that is retained within the group. Paragraph 82A states:

> In the circumstances described in paragraph 52A, an entity shall disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. In addition, the entity shall disclose the amounts of the potential income tax consequences practicably determinable and whether there are any potential income tax consequences not practicably determinable.

18. We therefore retain our view that although there are disclosures in IFRS that relate to the investors' request, there is not a specific requirement that ensures that the disclosures are made. Having said that, there is nothing in IFRS that prevents preparers from including additional disclosures to address investors' requests in their financial statements.

## Feedback from the GPF

19. As requested by the IASB, we asked the GPF for its assistance in developing disclosure requirements about cash and cash equivalents. We asked the GPF for advice on four questions:

    *(a)* *Whether GPF members think there is a problem with a lack of disclosure about matters such as taxation consequences of moving cash within a group?*

    GPF members noted that, at most, they could accept that IAS 7 makes a specific reference to the disclosures in paragraph 81(f) of IAS 12.

(b) *Whether GPF members are aware of examples of constraints, beyond the taxation and foreign currency examples mentioned in the accompanying note?*

The GPF noted that there can be many instances in which remittance of cash or equity is restricted, including local liquidity and specific financing requirements relating to a subsidiary.

(c) *Whether a disclosure that requires entities to explain any economic restrictions, such as tax consequences that would affect an entity from freely moving cash within their group, such as between jurisdictions or entities, could provide meaningful information to investors?*

The GPF considered that the disclosures could be meaningful to investors but care is needed in drafting the disclosure requirements to ensure that the additional costs and time that would be involved in preparing the disclosures are commensurate with the benefits for investors.

(d) *Whether the IASB should propose such a disclosure requirement as part of the proposed amendments to IAS 7?*

The GPF noted that any proposed disclosure would need to be broader than just cash and cash equivalents and include marketable securities. GPF members also noted that any additional IFRS disclosure should not go further than the current requirements of US GAAP or the SEC for US listed companies.

20. The SEC disclosure requirements regarding the notes to the financial statements address restrictions that limit the payment of dividends.[1] They require in certain circumstances a description of the nature of any restrictions on the ability of consolidated subsidiaries and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances and disclosure of the amounts of such restricted net assets for unconsolidated subsidiaries and consolidated subsidiaries as of the end of the most recently completed fiscal year.

[1] US SEC regulations concerning general notes to the financial statements—restrictions that limit the payment of dividend by the registrant. Reg. § 210.4-08.

21. The SEC disclosure requirements provide that not all limitations on transferability of assets are considered to be restrictions for the purpose of making the disclosure. The disclosure considers only specific third-party restriction on the ability of subsidiaries to transfer funds outside of the entity.

22. In addition to the disclosures required in the notes to the financial statements there are also disclosure requirements relating to the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). The SEC Guidance to the MD&A requires companies to provide disclosures about liquidity and capital resources. The MD&A Guidance focuses on narrative disclosures and includes requirements for a company to discuss the effect of an inability to access the cash flow and financial assets of any consolidated entities,[2] including the assets that are legally isolated.

23. The MD&A Guidance notes that this information is critical to an assessment of a company's prospects for the future and even the likelihood of its survival. It is important to note that the guidance on the MD&A is linked to the general disclosures required in the notes in the financial statements outlined in paragraph 20.

24. Although the SEC disclosures are more descriptive and may generate additional disclosures to those required by current IFRS (namely IFRS 7 *Financial Instruments: Disclosures* and IFRS 12 *Disclosure of Interests in Other Entities*), our analysis suggests that the disclosures would not necessarily capture the information that investors are requesting as to whether cash is freely available.

## Possible approaches

25. As noted above we do not consider that current Standards specifically address the disclosures that are being requested by investors which relate to the assessment of the entity’s liquidity. However, to capture the information that is being requested in a

[2] Commission guidance regarding management’s discussion and analysis of financial condition and results of operations, liquidity and capital resources, sources and uses of cash.

disclosure is difficult because what is being requested is information about how the entity manages liquidity and the consequences if liquidity risks were to crystallise.

26. We also note that in its response the GPF highlighted that any disclosure would need to be broader than cash and cash equivalents and include marketable securities. Some entities that make voluntary disclosures of net debt include marketable securities in addition to cash and cash equivalents. An entity that decides that, economically, it is better to retain cash and cash equivalents balances in an overseas subsidiary and seeks an alternative form of finance will also seek to maximise its returns on cash and cash equivalent balances retained by the subsidiary, and may decide to invest these balances in liquid marketable securities. We therefore agree with the GPF that, to be effective, the disclosure would need to be broader than cash and cash equivalents. If an amendment were to include liquid assets, then liquid assets would need to be defined. We think such a definition is outside the scope of an amendment to IAS 7.

27. Consequently, any proposed disclosure needs to improve disclosures about how an entity manages liquidity, including how an entity sources its finance and manages both its assets and liabilities in relation to liquidity.

28. The staff do not consider that paragraph 48 of IAS 7, which requires disclosure of significant cash and cash equivalent balances that are held by an entity that are not available for use by the group, answers the request from investors. The cash and cash equivalent balances are available but the entity has assessed that it is more economical to use an alternative source of finance instead of using the cash held in an overseas subsidiary. In addition, the GPF has noted that the disclosure would need to be broader than cash and cash equivalents. On balance, the staff consider that the scope of the proposed amendments that would be required to address the concerns of investors about liquidity are outside the scope of amendments to IAS 7 and possibly relate to IFRS 7.

29. One possible approach that has been identified is to amend paragraph 13 of IFRS 12. Paragraph 10 of IFRS 12, which requires an entity to disclose information that enables users of its consolidated financial statements to evaluate the nature and extent of significant restrictions on its ability to access or use assets and settle liabilities of the

group, could be amended to capture the request from investors. Paragraph 13 of IFRS 12 requires:

> An entity shall disclosure:
>
> (a) significant restrictions (eg statutory, contractual and regulatory restrictions) on its ability to access or use the assets and settle the liabilities of the group, such as:
>
> (i) those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group.
>
> (ii) guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group.
>
> …

30. The possible amendment could require disclosures about economic impediments in addition to significant restrictions. An economic impediment would include taxation consequences or exchange costs that give rise to some assets not being freely available to the group.

31. This disclosure would be in addition to an amendment to IAS 7 and preparers may seek guidance of the meaning of economic impediment. It would also not address the circumstances in which the cash and cash equivalents are held in overseas branches. While this is a possible approach, the staff consider that it would be better to spend more time considering the suggestion as part of the Disclosure Initiative: Principles of Disclosure research project.

32. It is further noted that in its previous discussions the IASB has not reached a consensus on whether disclosure should be developed; whereas it has agreed, subject to confirmation that it has satisfied the due process requirements, to issue an Exposure Draft of proposed amendments to IAS 7 to improve disclosures financing activities (debt). Continuing the discussion about disclosures of cash and cash equivalent balances will delay issuing this Exposure Draft.

33. Also, the IASB is proceeding with the Disclosure Initiative: Principle of Disclosures research project which, in co-operation with the UK Financial Reporting Council, is reviewing IAS 7 more fundamentally.

## Staff recommendation

34. On balance, the majority of the staff recommend that the IASB considers improving disclosures about cash and cash equivalents as part of its Disclosure Initiative: Principles of Disclosure research project.

| Recommendation |
| --- |
| Does the IASB support improving disclosures about cash and cash equivalents as part of its Disclosure Initiative: Principles of Disclosure research project? |

## APPENDIX 1

### Current IFRS disclosures

IAS 7 *Statement of Cash Flows* requires the disclosure of:

(a) the components of cash and cash equivalents (paragraph 45); and

(b) the amount of significant cash and cash equivalents balances held by the entity that is not available for use by the group (paragraph 48).

The objective of IFRS 12 *Disclosure of Interests in Other Entities* is to require an entity to disclose information that enables users of its consolidated financial statements to evaluate the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group.

Paragraph 13 of IFRS 12 requires an entity to disclose:

> (a) significant restrictions (eg statutory, contractual, and regulatory restrictions) on its ability to access or use assets and settle liabilities, of the group, such as:
>
> (i) those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group.
>
> (ii) guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group.
>
> …

Paragraph 39 of IFRS 7 *Financial Instruments: Disclosures* contains disclosures regarding liquidity risk. These disclosures address the maturity of financial liabilities and a description of how an entity manages the liquidity risk inherent in its financial liabilities.

Paragraph 66(d) of IAS *1 Presentation of Financial Statements* requires an entity to classify an asset as current when:

> … the asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.