

## STAFF PAPER

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Project	Primary Financial Statements		
Paper topic	Improving the Statement of Cash Flows		
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### Overview of this session

1. The staff of the UK Financial Reporting Council (FRC) have been researching issues related to the statement of cash flows, with the aim of identifying possible improvements to IAS 7 *Statement of Cash Flows*. The FRC staff intends to set out suggestions in a Discussion Paper, responses to which may assist the Board to consider what changes might be made to the cash flow statement. This would probably form part of the Board's work on its 'Primary Financial Statements' project.
2. A preliminary draft of the Discussion Paper is at Agenda Paper 3A. This draft is to provide background for the CMAC/GPF discussions: it is not expected that CMAC/GPF members will study it in detail, although signposts to the most relevant material in the Discussion Paper are included in this paper. An Appendix to the draft Discussion Paper provides an illustration of how its suggestions might be applied, and how they would differ from a cash flow statement that complies with the current requirements of IAS 7.
3. The research carried out by the FRC staff for this project included a review of relevant previous IASB Board and staff work—in particular the IASB Discussion Paper *Preliminary Views on Financial Statement Presentation* of October 2008 and the staff draft of an Exposure Draft (developed jointly by the IASB and FASB staff) that followed in 2010, including responses received on that work. The

research also involved a review of academic and practitioner literature, and unstructured FRC outreach to investors.

4. The FRC's work on cash flow statements was previously discussed by the CMAC in October 2014 and by the GPF in November 2014.
5. Comments or observations on the draft Discussion Paper outside of this meeting would be welcome. The suggestions made in the Discussion Paper are not official positions of either the FRC or the IASB Board.
6. It should be noted that the Discussion Paper does not attempt to provide a comprehensive discussion that addresses every issue that might be considered in the context of the statement of cash flows. For example, it does not address the cash flow statement of banks, insurance companies and other financial institutions, nor does it discuss how the Board might deal with restrictions on cash.
7. The next section of this paper (paragraph 9) provides a summary of the main ideas explored in the draft Discussion Paper.
8. The specific issues that the CMAC/GPF are asked to discuss are set out in the final section of this paper (paragraph 10).

### **Summary of principal suggestions**

9. Among other suggestions, the draft Discussion Paper suggests changes to the following topics:

#### *The objective of the statement of cash flows (Draft Discussion Paper, Section 2)*

- (a) IAS 7 states that its objective is '*to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities.*' However, the draft Discussion Paper argues that, like the FASB's former SFAS No. 95 *Statement of Cash Flows*, which resembles IAS 7 in many respects, IAS 7 attempts to restate information in the statement of profit or loss (and particularly earnings or net income) on a cash

basis rather than an accruals basis. The draft Discussion Paper suggests that a surer foundation for a useful statement of cash flows is to identify its principal purpose as assisting an assessment of the entity's liquidity and changes in that liquidity.

*The classification of cash flows (Draft Discussion Paper, Section 3)*

- (b) The Discussion Paper suggests that IAS 7's classification of cash flows between operating, investing and financing should be retained, but with the following modifications:
- (i) Under IAS 7, 'operating activities' by definition include all activities that do not meet the definition of investing or financing activities. The draft Discussion Paper suggests that operating activities should be positively defined or described (perhaps as including transactions with customers, employees and suppliers) and that items that do not relate to operating activities (or another defined section of the cash flow statement) should be reported separately. It should also be clear that items should not be excluded from operating activities merely because they are unusual or non-recurring.
  - (ii) Cash outflows to acquire property, plant and equipment should be reported as a cash outflow from operating activities rather than within investing activities. As such outflows are likely to change significantly from period to period, a sub-total of cash generated from operating activities before capital expenditure should be disclosed. Entities should be encouraged to disclose the extent to which expenditure on property, plant and equipment that represents 'replacement' and 'expansion'—as is currently the case under IAS 7.
  - (iii) Cash flows related to financing liabilities (including the payment of interest) should be reported in the financing category of the cash flow statement. Cash received from customers (including any amount treated as interest income in the statement of profit or loss) should be reported within cash flow from operating activities.

- (iv) Cash flows relating to tax should be reported in a separate section of the statement of cash flows. Currently they are required to be reported within cash flow from operating activities (unless they can be specifically identified with financing and investing activities).

*Cash equivalents and the management of liquid resources (Draft Discussion Paper, Section 4)*

- (c) IAS 7 defines cash flows as inflows of cash and cash equivalents because movements in cash equivalents are deemed to be part of the entity's cash management activities. The definition of cash equivalents is vague, and cannot reflect how all entities manage cash and liquid resources. It is therefore suggested that the statement of cash flows should report inflows and outflows of cash, rather than cash and cash equivalents, and that a separate section of the statement of cash flows should report 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. Entities should be required to disclose their policy for the management of liquid resources, and the classes of instruments that are treated as such.

*Reconciliation of operating activities (Draft Discussion Paper, Section 5)*

- (d) A reconciliation of profit or loss and cash flow should be presented in all cases, rather than only where an indirect method cash flow statement is presented as is current practice. The reconciliation assists with an assessment of the quality of earnings, and the management of working capital. The reconciliation should be required to reconcile a sub-total in the statement of profit or loss that represents operating income or loss (rather than, for example, net profit or loss) and reconcile that to cash flow from operating activities. Because the amounts reported in the reconciliation are not cash flows, the reconciliation should not be reported within the statement of cash flows itself, but as a supplementary note.

*Direct or indirect method (Draft Discussion Paper, Section 6)*

- (e) 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. However, 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.

### Issues for discussion

10. GMAC and GPF participants are invited to discuss the following:

#### **Q1. The classification of cash flows**

1. Do CMAC members think that the modifications set out in 9(b) above will provide them better information than they receive today and will improve the statement of cash flows?
2. Do GPF members foresee any practical problems with the proposed modifications?

#### **Q2. Cash equivalents and the management of liquid resources**

Do you agree that the statement of cash flows should report flows of cash, rather than cash and cash equivalents, with the management of liquid resources being dealt with in a separate section of the cash flow statements?

#### **Q3. The reconciliation of operating activities and the direct method**

CMAC members: Would a reconciliation from operating profit or loss to cash flow from operating activities assist you in assessing the quality of earnings, and the management of working capital, even where a direct cash flow statement is presented?

GPF members: Do you foresee any issues in preparing or providing this information?