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National standard setter input on the objective(s), the uses of and issues with the statement of cash flows

Issues Paper

Objective

1 The purpose of this session is to receive input from the EFRAG CFSS for EFRAG's proactive research project on the statement of cash flows. Input is sought on:

(a) What is/are the objective(s) of the statement of cash flows?

(b) How is the statement of cash flows (as prepared under the requirements in IAS 7 *Statement of Cash Flows*) used by users?

(c) What are the issues with how the statement of cash flows are currently prepared (under the requirements of IAS 7)?

Background

2 Following the 2021 consultation on EFRAG's research agenda, EFRAG decided in June 2022 to include on its research agenda a project on the statement of cash flows (see EFRAG feedback statement).

3 The reasons stated for adding this project to the EFRAG proactive agenda were that:

(a) the project could be useful for the IASB, as the IASB has also decided to include a project on the statement of cash flows and related matters as research pipeline projects following its Request for Information (RfI) on its Third Agenda Consultation; and

(b) the project could encompass supply financing arrangements, which was deemed as a suitable EFRAG proactive research project.

4 EFRAG will issue a Discussion Paper for public comments that will:

(a) List, and shortly discuss, different alternative objectives/uses of the statement of cash flows. This will include considering whether the statement should reflect, changes in cash, changes in cash and cash equivalents or changes in working capital or net debt.

(b) List the issues with current requirements/practice. The issues would be categorised/labelled according to which use/object of the statement of cash flows (in (a)) they would be related to.

(c) Discuss whether the IASB could consider the issues by targeted amendments, or a comprehensive review would be necessary to deal with the issues in a satisfactory manner.

5 According to the IASB staff, input on (a) and (b) above would be useful for the IASB when considering its project on the statement of cash flows.

6 As part of its project, EFRAG has asked a contractor to collect information on (a) and (b) above.

7 The EFRAG Secretariat has already collected input from EFRAG FR TEG, EFRAG User Panel, EFRAG FIWG, EFRAG IAWG and the EFRAG Academic Panel. This input is summarised in the appendix of this paper to stimulate the discussion of the EFRAG CFSS. From November to December 2023, EFRAG is also conducting a series of roundtables to collect input from stakeholders with different backgrounds.

Questions for the EFRAG CFSS

8 What do you consider the objective(s) of the statement of cash flows to be?

9 Do you consider that for certain sectors/business models, information on changes in cash flows is not useful? If so, which alternative information, if any, would be more useful?

10 How is the statement of cash flows (prepared under the requirements in IAS 7) used?

11 What do you consider are the issues with how the statement of cash flows are currently prepared (under the requirements of IAS 7)?

Appendix: Identified objectives/uses of and issues with the statement of cash flows identified by EFRAG FR TEG and EFRAG working groups

Objectives of the statement of cash flows

1 The following views have been expressed:

(a) there is no primary objective for the statement of cash flows. It shows where an entity got its money from and what it did with the money;

(b) the objective is to explain why cash has not changed with the net profit of the period;

(c) the objective is to provide information on liquidity (specifically insurance companies);

(d) the objective is to depict the 'rhythm' of the operating, investing and financing cash flows;

(e) the objective is to describe an entity's business model;

(f) the objective is to provide information to be used for discounted cash flows evaluations;

(g) the objective is to offer a collection of information that can be used by users in their own analyses on e.g., credit worthiness; and

(h) for financial institutions (banks), the objective should be to provide information on liquidity risk (as the statement of financial position may not reflect problems with liquidity).

(i) provide information on the capability to invest and to pay dividends.

How the statement of cash flows is used

2 The following uses were mentioned:

(a) to assess management's stewardship — how the management is dealing with the cash the entity is generating (CapEx policies, capital policies, what is financed, impact on statement of financial position, free cash flow generated compared to invested capital);

(b) to help reconcile movements in net debt (e.g., what is repayments and what is interest) to calculate cash yield numbers);

(c) to help reconcile cash movements;

(d) to assess liquidity;

(e) to understand working capital dynamics (e.g., how much working capital is absorbed as the entity grows);

(f) to compare CapEx with depreciations (to assess whether entities are growing – and for corrections to discounted cash flows projections). It is used to assess what profit is realised (and not e.g., changes in fair values); and

(g) it is currently not used much for banks - for internal purposes/by users/by regulators.

Issues with the statement of cash flows

3 The following issues/views have been mentioned:

(a) The statement of cash flows is prepared very differently from one entity to another (different layout and different categorisation of cash flows). Comparability is an issue.

(b) Dividends to non-controlling interests are often included in the same figure as dividends to the entity's shareholders.

(c) Business combinations complicate the interpretation of the information in the statement of cash flows.

(d) It could be more useful to reconcile net debt (net financial obligation or net interest-bearing instruments or something similar).

(e) The usefulness for assessing liquidity could be improved (see also point on restrictions on cash).

(f) It might not be possible/useful to achieve 'cohesiveness' with the labelling in the statement of financial performance. For example, operating income is after depreciations, but cash flows from operating activities is before CapEx - and analysts did not want to change that.

(g) The current disclosures around the statement of cash flows are insufficient (e.g., on non-cash transactions, working capital, covenants, restrictions on cash (e.g., in the consolidated statement of cash flows). Disclosures could also be improved on liquidity (which would be relevant for banks) by providing e.g., Liquidity Cover Ratio (LCR) and the Liquidity Mismatch Index (LMI) and for insurance companies maturity analyses of insurance liabilities and CSM.

(h) Cash is not defined and it is unclear what cash equivalents comprise (i.e., there are different views on what 'cash equivalents' consist of.

(i) The exclusion of certain transactions/classification of certain transactions including an intermediary is not useful (e.g., investments made by share-based payments, supplier finance arrangements, leases and purchase of an asset with deferred payment terms).

(j) For creditors and bond analysts it would be more useful to only consider changes in cash and not also cash equivalents.

(k) Interest payments can be presented as operating activity.

(l) As there is room for judgement on whether certain research and development costs should be capitalised or not (CAPEX versus OPEX), there is an opportunity for entities to manage how certain cash flows are categorised—and hence the level of some key ratios such as the cash conversion ratio.

(m) The indirect method of presenting cash flows from operating activities could give the impression that write downs of inventory affected cash flows positively.

(n) There is divergence in practice on how to present interest on trade receivables, interest on trade payables, dividends received, cash flows related to derivatives and how to present changes in working capital (one line versus several line items).

(o) To the extent investing cash flows are used to assess the level of investments an entity makes, this measure is imperfect, as it would not reflect investments paid in shares.

(p) It is not useful to taxes in operating cash flows.

(q) It is not required to distinguish cash flows related to investments in tangible assets from cash flows related to investments in intangible assets. Such a distinction could be useful.

(r) The statement is not useful for banks (as it does not focus on providing information on liquidity risks) and to some extent also not for insurance companies (but the issues for banks and insurance companies are not completely the same (insurance companies can be illiquid but solvent) – and there may also be differences between non-life and life insurances). The issue may be further complicated by the existence of conglomerates including both banking and insurance businesses. (An opposite view has, however, been expressed that the usefulness would depend on the bank's business model. For transaction services, the statement of cash flows could provide useful information. In addition, trading financial instruments was not different from trading other things. The statement of cash flows could also provide information on the amounts lend and the amounts recovered.)

12 The indirect method to present cash flows from operating activities was generally considered most useful by the (European) EFRAG working group members. Cases where the direct method was most useful included when there were significant business combinations. The direct method would also provide more granular information about the differences between operating cash flows and the related items in the statement of performance.