Objectives, usages and issues

THE STATEMENT OF CASH FLOWS

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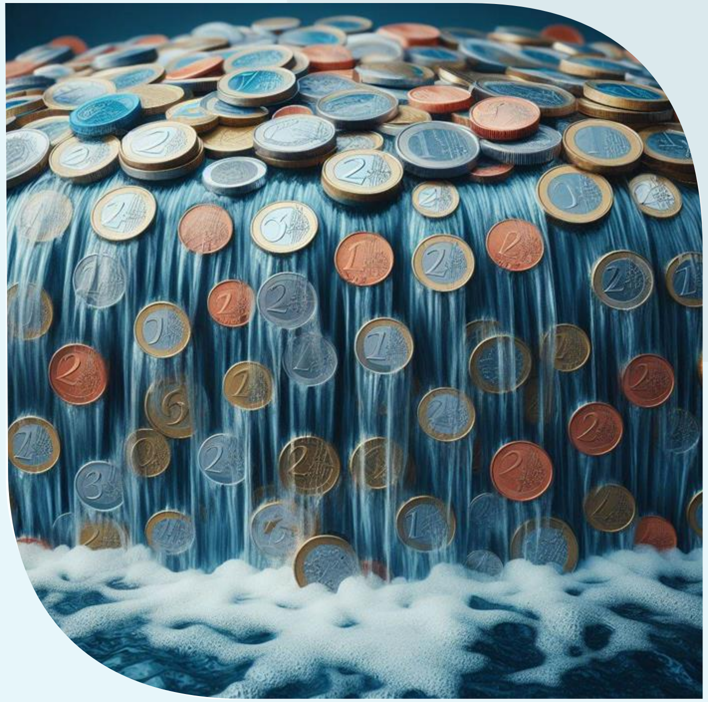

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OVERVIEW

- Objectives and usages of the statement of cash flows for non-financial entities
- Issues with how the statement of cash flows is currently prepared under IAS 7 *Statement of Cash Flows* for non-financial entities
- Alternatives to the statement of cash flows for non-financial entities
- The statement of cash flows from financial institutions
- Targeted improvements versus a comprehensive review

Objectives and usages

Possible objectives

Clarifying the objectives of the statement of cash flows is important as the objectives as providing more relevant information for one objective might result in less relevant information for another objective.

The benefits of the statement of cash flows presented in the Conceptual Framework and IAS 7 could be categorised as follows:

- Assessment of the amount, timing and uncertainty of future net cash inflows
    - Evaluating the changes in net assets
    - Assessing the entity's financial structure
    - Assessing the entity's ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities
    - Assessing the ability of the entity to generate cash and cash equivalents
    - Comparing entities as it eliminates the effects of using different accounting treatments for the same transactions and events
- Assessment of the management's stewardship

Usages (1/2)

- Input from input from users and academic literature.
- Academic literature and input from users of financial statements indicate that the statement of cash flows is used (together with other information) for the stated objectives—but the usage of the statement of cash flows depends on the individual user.
- The statement of cash flows is used to:
  - Assessment of the amount, timing and uncertainty of future net cash inflows
    - Understand the business
    - Assess accruals (closeness to cash and evaluation of changes)
      - Although the statement of cash flow is used by some to assess the ‘quality of earnings’ academic studies indicate that a trading strategy with a long position in low accrual firms and a short position in high accrual firms generates significant abnormal returns in the subsequent years and that high levels of accruals are not reflected in sell-side analysts’ earnings forecasts
    - Assess ability to service debt
      - But academic literature states that EBIT and EBITDA is often used as an ‘easier’ alternative (but not by all)

Usages (2/2)

- Assessment of the amount, timing and uncertainty of future net cash inflows
    - Assessing the agility adaptability of the entity
        - Not often mentioned by users providing input to EFRAG. Only mentioned in relation to DCF analysis (to assess whether entities would need additional financing in the future)
    - Assessing the ability of an entity to generate cash and cash equivalents
        - Academic research points in different directions on whether cash flows or earnings figures are best for predicting future cash flows (FASB and IASB: earnings figures are best). Most (not all) academic literature shows that the statement of cash flows includes additional (in addition to the statement of profit or loss) useful information for this
        - Input received from EFRAG indicates that many/some users only use the CapEx figures from the statement of cash flows. They estimate cash flows based on the statement of profit or loss. Academic literature indicates that there is additional information in the statements prepared by entities and preparers consider that they can do it better than analysts as they have access to additional information
    - Assessing the effects of different accrual accounting practices
        - Not a point of focus amongst users providing input to EFRAG

Issues

Issues (1/3)

- Cash and cash equivalents
  - Uncertainty about what is included in ‘cash and cash equivalents’
  - What is considered ‘cash and cash equivalents’ is not considered to result in the most relevant information for all objectives (but changes will not be beneficial for all objectives)
- Principal/agent transactions
  - Uncertainty about/diversity in practice on how to reflect these transactions
  - Not including cash flows of agents may not result in comparable and the most relevant information
  - Including cash flows of agents may not be a faithful representation and impede understandability
- Multiple component transactions that are not principle/agent transactions
  - Not including cash flows of agents may not result in comparable and the most relevant information
  - Including cash flows of agents may not be a faithful representation and impede understandability

Issues (2/3)

- Non-cash transactions
  - Excluding certain non-cash transactions does not result in comparable information
  - Excluding certain non-cash transactions does not result in the most relevant information for all objectives (but including non-cash transactions may impede other objectives, faithful representation and understandability)
- Issues with classification
  - Diversity in practice in relation to some types of cash flows
  - Classification does not result in the most relevant information for certain transactions (some changes would, however, affect the relevance of the information for other objectives or faithful representation)
- Insufficient disclosures
  - E.g. on restrictions on cash and where the cash is; non-recurring cash flows; the impact of business combinations and reconciliations

Issues (3/3)

- Need for more disaggregated information
  - E.g. maintenance versus growth CapEx—but some consider that it will not be possible to get additional useful information on this (relevance versus faithful representation)
- Definitions
  - Free cash flows, working capital, net debt, maintenance vs. growth CapEx
- Cohesiveness with other financial statements
  - Would generally be preferable, but no appetite for not having depreciations in the operating category in the statement of profit or loss and not having CapEx in cash flows from investing activities
- Presentation of cash flows from operating activities
  - Academic literature generally finds the direct presentation most useful, but European users prefer the indirect presentation

Alternatives to the statement of cash flows for non-financial entities

Alternatives

- Statement of changes in net debt
- Statement of changes in working capital
- Changes in other liquid assets (together with the statement of cash flows)
- Changes in assets used in liquidity management (together with the statement of cash flows)

The statement of cash flows for financial institutions

Issues for financial institutions

- No exception to prepare a statement of cash flows for financial institutions.
- Often hear that a statement of cash flows is not useful for financial institutions (e.g. EFRAG's Discussion Paper: *The Statement of Cash Flows: Issues for Financial Institutions* and related feedback).
- However, also some academic(s) (research) and users claiming that is has/could be useful.
- Arguments for why the statement is not useful include:
  - the business model of financial entities;
  - limited information on liquidity and solvency in the statement of cash flows;
  - insufficient disclosures accompanying the statement of cash flows;
  - the classification into operating, investing and financing categories is not useful.

Alternatives for financial institutions

Alternatives for financial institutions could include:

- regulatory ratios (for banks);
- information about dividend payout capacity (for banks);
- a flow of regulatory capital (for banks);
- a standardised table with stress-testing scenarios (for banks and insurers).Statement of changes in net debt

However, concern about included in financial statements information prepared under other frameworks.

Targeted improvements versus comprehensive review

Targeted improvements or a comprehensive review?

- Targeted improvements:
  - Possible to make improvements relatively fast.
  - But dealing with issues such as including non-cash transactions would need some rethinking—so approach not useful for all types of changes.
- Comprehensive review:
  - Could deal with all issues and ensure consistency across the requirements.
  - Would take many years to complete.
- Phased approach:
  - Some issues could be addressed relatively fast, and all issues could eventually be addressed.
  - Could result in amendments being changed (again) within a short time frame.

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