This report is a continuation from the first part i.e., objectives and uses of the statement of cash flows of corporates and financial institution. In this phase, we discuss the issues with how the statement of cash flows is prepared for corporates and financial institutions.

Issues with how the IAS 7 Statement of Cash Flows is prepared

EFRAG PROACTIVE RESEARCH PROJECT STATEMENT OF CASH FLOWS – PHASE 2

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Contents

Executive Summary

This report looks at the issues with how the IAS 7 Statement of Cash Flows of corporates is prepared. The discussion in this phase of the Statement of Cash Flows proactive research project focuses on the various issues with the preparation of the IAS 7 Statement of Cash Flows of corporates which hamper its effective usefulness to the users of corporates' financial statements.

We base the discussion on the following sources:

- Academic Literature
- EFRAG Working Group Meeting and Statement of Cash Flows roundtable sessions
- IFRIC discussions
- Latest accounting manuals/periodicals of accounting firms.
- Previous studies conducted by other regional financial reporting advisory groups.

We as Zielke Research Consult GmbH conducted a literature review to search for relevant academic literature related to the issues with the statement of cash flows. We also obtained other relevant literature shared to us by the EFRAG team together with additional ones as shared by the respondents during the various EFRAG Working Group Meetings such as the Academic Panel session and roundtable session that were conducted over the course of the project.

It is to be noted that most of the literature pertaining to the statement of cash flows was in the 1990s and the recent literature post 2000 discuss the direct and indirect method. However, there is still limited academic analysis on the subject matter.

Hence, in this report we have only picked the most relevant literature that discuss the various issues with the statement of cash flows.

Introduction – Issues with the IAS 7 statement of cash flows- Corporates

The IAS 7 statement of cash flows is one of the key primary financial statements. The objectives and uses of the statement of cash flows of corporates have already been discussed in the first part of this proactive research project.

This second phase of the corporate part deals with the various issues relating to how the IAS 7 statement of cash flows is prepared. As it was observed in the various EFRAG roundtable sessions relating to the statement of cash flows project, various stakeholder groups from investors, analysts, academics and preparers opined that the current IAS 7 Statement of Cash Flows does have issues that need to be addressed accordingly. After considering the discussions which were held in the roundtable session, we believe that international accounting standard setters i.e. IASB and FASB should allocate the required resources to address the various issues pertaining to the statement of cash flows so that users of financial statements can make a better evaluation and assessment of a firm's performance. (Zielke Research Consult GmbH)

Therefore, the discussion is structured in the following way. Chapter 1 discusses the debate between the direct and indirect method. Chapter 2 deals with certain classification issues pertaining to certain transactions. Chapter 3 shortly discusses the definition and classification of cash for cryptocurrencies and central bank digital currencies. Chapter 4 deals with cash equivalent matters i.e. money market funds. Chapter 5 highlights the manipulation issue of the statement of cash flows. Chapter 6 focuses on the various additional disclosures and Chapter 7 concludes the discussion in this report.

The objectives and uses of the statement of cash flows as discussed in part 1 of the proactive research project

In the recent EFRAG FR TEG meeting held on 01.07.2024, a panel member noted that to the objectives and uses of the statement of cash flows should be merged into one chapter and there was no need of having separate sections for the objectives and uses.

We believe that this could be an appropriate approach when dealing with the issues of the statement of cash flows of corporates as we would be able to link the various issues identified to the objectives and uses of the statement of cash flows. (Zielke Research Consult GmbH).

Therefore, the following are the objectives and uses of the statement of cash flows of corporates as discussed in part 1 of this research project:

Figure 1: Objectives of the statement of cash flows of corporates

Objectives of the statement of cash flows of corporates
1. To provide information about the financial structure of an entity **- Liquidity** **- Solvency**
2. Movements of cash and cash equivalents
3. Interaction of cash balance with net income

Source: Zielke Research Consult Report-1

Figure 2: Uses of the statement of cash flows of corporates

Uses of the statement of cash flows of corporates
1. Analyzing capital expenditures **- Importance of capital intensity to investors** **- Operating cash flows and capital expenditure**
2. Assessing dividend possibilities
3. Valuation **- Association with stock returns, prediction of future cash flows, and providing information on accruals**
4. Assessing an entity's financial structure **- Liquidity** **- Solvency**
5. Explain an entity's business model and life cycle
6. Assessment of management stewardship

Source: Zielke Research Consult Report-2

1- The Direct vs Indirect Method

IAS 7 (18(a)(b) states that the cash flows from operating activities can be reported by an entity either through the direct method where the major classes of gross cash receipts and payments are disclosed or the indirect method where the profit or loss is adjusted for the effects of transaction that are non-cash in nature, any deferrals or accruals of past or future operating receipts or payments and items of income or expense associated with investing or financing cash flows.

As the cash flows from operating activities can be presented either using the direct or the indirect method, the underlying issue then results into a comparability problem.

We hereby discuss this matter and present the perspective of the academic literature and what it says as regards to the issue of the direct and indirect method.

Academic Research on the Indirect Method

According to (Wallace et al., 1997 & Troberg, 2007) most of the corporates prefer using the indirect method of presenting the cash flow from operating activities. The reason for using the indirect method by most of the corporates is that they regard it as easier to prepare compared to the direct method (Hertenstein & Mc Kinnon 1997). (Kwok 2002) argues that the indirect method does not require additional recording.

This however has not been the case as (Broome, 2004) points out that, 90% of companies' statement of cash flows is presented using the indirect method. As company's size increases together with the concentration of ownership and as well as the selection of a Big 4 auditor, it becomes inevitable that the default nature of presenting the cash flows from operating activities becomes the indirect method (Mailibayeva et al., 2012).

Nevertheless, the preference of preparers in using the indirect method of presenting the cash flows from operating activities opened doors for the practice of manipulation of the statement of cash flows as (Broome, 2004) reports that the US companies which were caught manipulating their statement of cash flows in the early 2000s used the indirect method of presenting cash flow from operating activities.

Academic Research Supporting the Direct Presentation

(Broome, 2004) argues that the direct method of presenting cash flows from operating activities allows for the categorization of the cash flows, whereas the indirect method's adjustments make it difficult for users to understand. The indirect method as highlighted by him, provides preparers a room for manipulating the statement of cash flows. According to a survey conducted by (Jones et al., 1995) of 210 Australian preparers, majority of them reported that the direct method helps users to easily understand the cash flow data and make better cash flow analysis as well as providing information about an entity's financial structure i.e., solvency. This was reiterated by (Brahmasrene et al., 2004) where they highlighted that the direct method provides users with a breakdown of the cash inflows and outflows as well as its format being easy to understand.

According to (Hales & Orpurt, 2013), presenting cash flows from operating activities using the direct method has long term benefits which exceed the recurring costs. IAS 7 (19) encourages entities to report their cash flows from operating activities using the direct method as it provides information that could be useful in estimating future cash flows to which the indirect method does not provide.

In a study conducted by (Farshadfar & Monem, 2013), they concluded that the disaggregation of cash flows from operating activities into components improves the predictive ability of cash flows from operating activities in the prediction of future cash flows. (Orpurt & Zang, 2009) also add that the cash received from customers under the direct method cannot be easily estimated using the balance sheet, income statement and the indirect method and for this reason the direct method is useful in predicting future cash flows from operating activities and earnings. In their study they find out that market participants use the information from the direct method in setting up share prices and provides investors valuable information in predicting the future performance of an entity than the information content in the indirect method. (Epstein et al., 2005) also reports that the interviews which were conducted by the FASB as part of their project on financial performance reporting, creditors, equity analysts and investors preferred the direct method of presenting the statement of cash flows. Finally (Hales & Orpurt, 2013) came to the conclusion after considering many years of reporting and multiple reporting jurisdictions, that the information contained in the direct method statement of cash flows is superior to the indirect method and hence, the information contained in the direct method statement of cash flows is used in the prediction of future operating performance of an entity.

Users of financial statements supporting the Indirect Method – Contrast

However, there is also academic literature which supports the idea that the indirect method of presenting statement of cash flows is more useful than the direct method. According to the survey conducted by (Brahmasrene, 2004), 70% of the investors and analysts and 82% of the of managers, CEOs and CFOS, preferred the indirect method over the direct method. (Anthony, 1997) highlights that the reason some users prefer the indirect method is that it provides reasons for differences between the net income and change in cash from operating activities whereas (Broome, 2004) remarks that it facilitates users to understand the cash that is tied up in current assets and liabilities.

In another study conducted by (Troberg, 2007), it was noted that as the focus in capital markets is on net income and Earnings per Share (EPS), the indirect method is much relevant because it shows the difference between reported earnings and the change in cash and cash equivalent as well as the relationship between the two.

Views from the roundtable session pertaining to the Direct and Indirect method

During the corporate roundtable session, a user representative posed a question to the panel members i.e. most being preparers about their preference as to whether they would either use the direct or indirect method. The following were excerpts from the opinions of the various panel members:

Panel Members	View/Opinion
Preparer 1	*Indirect Method – they use the indirect method as it provides information to investors such as operational cash flows. She added that the indirect method of presenting cash flows was already complicated. She further highlighted that if they were to shift to the direct method, it would be very complex to implement.*
Preparer 2	*He highlighted on the possibility of having a reconciliation between the direct and indirect method.*
Preparer 3	*She agreed with the above opinions and remarked that their company had attempted to draw up a draft version of the direct method but in the process failed to come up with a solution. She also remarked that it is difficult to implement the direct method in large companies due to multiple currency exposures*.
Preparer 4	*His company used the indirect method*
IASB Observer	*Nick Anderson being the IASB observer remarked that most companies use the indirect method. He also noted that most investors prefer the indirect method.*

Thus, it was noted by other preparers and users in the roundtable session that the information provided under the direct method would not help analysts to improve their forecasting. Therefore, as users are interested in understanding the differences (interaction) between operating profit and cash flows.

In the Academic Panel Meeting, an academic remarked that the indirect method was the standard practice used by preparers. However, there was a tendency of manipulation in the statement of cash flows for the various elements under the indirect method.

2- Classification Issues

We have categorized the classification issues into the following categories:

- The transactions are not classified in a comparable manner.
- The requirements and choices relating to classification do not result in the provision of relevant information.

Transactions are not classified in a comparable manner

As Munter (2023) notes, classifying the cash flows correctly as operating, investing and financing activities is the foundation of preparing and presenting the statement of cash flows. This provides investors with the understanding of the nature of an entity's activities that have generated and used the cash during a reporting period. Failure of classifying the cash flows into operating, investing and financing would lead to classification errors which may become material to an informed investor.

According to IAS 7(11) an entity should present its cash flows from operating, investing and financing activities in a way which matches the business as this allows users to assess the impact of these activities on the financial position of the entity and amounts of cash and cash equivalents. However, IAS 7 (12) also notes that single transaction could include cash flows that are classified differently. An example to illustrate this would be the cash repayment of a loan which includes interest and capital – the interest component may be classified as an operating activity whereas the capital component is classified as a financing activity.

In February 2012, the IASB had asked the interpretations committee to look upon requests pertaining to the issues about classification related to IAS 7. Later in March 2012, the Interpretations Committee noted that the primary principle for the classification of cash flows in IAS 7 is that cash flows should be classified on the basis of the nature of an activity in a manner that is most appropriate to the business of the entity in accordance with paragraph 11 of the IAS 7 together with the definitions of operating, investing and financing activities in paragraph 6 of the IAS 7 (IASB, 2013).

However, in March 2013, the Interpretations Committee discussed how the definitions of operating, investing and financing in IAS 7 could be made more clearer so that a consistent application of the primary principle would be practiced by preparers. The conclusion was that clarification of the primary principle was a matter that was too broad for the Interpretations Committee (IASB, 2013). Thus (EY 2024) remark that a diversity in how some transactions are presented in the statement of cash flows is inevitable.

Views from the roundtable session and EFRAG Working Group meetings

In the corporate roundtable session, panel members shared their views about the issues relating to classification in response to the following examples of transactions that were asked to them for their opinions pertaining to their classification:

- Cash contribution to a long- term employee benefit fund (operating or investing?)
- Cash received as compensation for an insured loss (operating or investing?)
- Cash purchase for purchase of PPE on deferred payments terms (investing or financing?)
- Cash Payment to meet rehabilitation obligation (operations or investing?)
- Cash received from a government grant (operating or financing?)
- Cash payment to a factor in a reverse factoring agreement (operating or financing?)

- Cash flows on initial or subsequent margin callas (operating, investing or financing?)
- Repayment of debt of an acquiree as a result of a change in control clause (investing or financing?)
- R&D expenses? (as highlighted by a preparer in the corporate roundtable session)

As a question to the panel members, the moderator (an auditor) posed the question as to whether the classification of cash flows as operating activities by default is a concern for preparers and users. One preparer noted that the definition of operating activities is not clear enough to inform stakeholders. This was echoed by an observer from the IASB who highlighted that the definition of what actually an operating activity is has been challenging and that there has to be a default classification and categorization as otherwise the classification of cash flows would be "scattered all over the place". Another preparer different from the earlier one also noted that, before it was easier to categorize transactions into investing and financing activities where the default would then be operating. However, due to the current business environment this has become challenging.

Contrary to these views, a different preparer who was an ex-equity analyst highlighted that he neither has a problem with the definition of classification of financing and investing nor with the remaining transactions being classified as operating activities.

Lastly, the first aforementioned preparer noted that in order to classify transactions accurately preparers are required to use judgement and the guidance provided for IFRIC is available. She concluded that investors are interested in the level operating activity and free cash flow as it is not significant for them where the cashflows are classified into (operating, investing and financing).

Therefore, we are of the opinion that an inaccurate and incorrect classification of cash flows into operating, investing and financing would affect the objective of the statement of cash flows in providing information about the financial structure (Objective 1), movement of cash and cash equivalent (Objective 2) and interaction of cash balance with net income (Objective 3). This would also mean that users would not be able to assess the financial structure of an entity, understand the business model and assess the management stewardship.

The requirement and choice relating to classification do not result in the provision of relevant information

Interest and Dividends

The issues pertaining to the classification of interest and dividends has existed but may have been (partly) solved by the amendments following to IAS 7 as a result of the Primary Financial Statement project of the IASB.

Sales taxes and other non-income tax cash flows

IAS 7(35) states that the cash flows arising from taxes on income shall be classified as cash flow from operating activities by default unless these cash flows arising from taxes on income can be identified with financing and investing activities. However, according to a recent accounting periodical issued by Ernst & Young it highlighted that the IAS 7 does not give guidance pertaining to the cash flows relating to other taxes such as Value Added Tax (VAT) and other types of sales tax and duties (EY,2024).

The discussion pertaining to Value Added Tax (VAT) as an agenda happened in 2005, when the International Financial Reporting Interpretations Committee (IFRIC). IFRIC had considered to add to its agenda a project for the clarification of whether cash flows reported in accordance with the IAS 7 Statement of Cash Flows should be measures as exclusive or inclusive of valued added tax (VAT) since there would be difference emerging especially with those entities that present their statement of cash flows using the direct method. However, IFRIC did not come up with an Interpretation on this subject matter as it claimed that the differences in reporting practices would not be “widespread”. It was also noted in the meeting that IFRIC would recommend the IASB that the issue of VAT is to be considered as part of the IAS 7 review (IFRIC, 2005).

Cash flows from supply-chain financing and reverse factoring arrangements

Cash flows from supply-chain financing and reverse factoring arrangements may pose a challenge to the preparers of the statement of cash flows. According to (EY, 2024), an entity that has entered reverse factoring arrangement would be required to determine to classify whether the cash flows under this arrangement are cash flows from financing activities or cash flows from operating activities. As per the (IFRIC) June 2020 and December 2020 meetings, the committee noted that reverse factoring arrangement are arrangements for which a financial institution agrees to pay the amounts an entity owes to the entity’s suppliers and then the entity agrees to pay the financial institution at the same date, or a date later after the suppliers are paid (IFRIC, 2020).

However, (EY, 2024) highlights that there are challenges for preparers to classify the cash flows of these arrangements into either cash flows from operating activities or cash flows from financing activities. These are:

- Does the presentation of the liability to the financial institution in the statement of financial position impact the presentation of cash flows? Example, if the liability does not relate to trade and other payables, should the payment to the financial institutions be classified as a financing outflow? Or should it be presented as an operating cash flow because of the nature of activities that led to the initial recognition of a trade payable?
- Will the payment to the supplier by the financial institution be reflected in the statement of cash flows, or will it be identified as a non-cash transaction? This issues, was also raised by one of the panel members i.e., an auditor in the roundtable session.

Receipt of a government grant

The COVID-19 pandemic gave rise to a situation where companies were in receipt of government grants to help them maintain operations and during those turbulent economic times. Currently there is no guidance in the statement of cash flows pertaining to the cash inflows of government grants.

According to (EY, 2024) the discussion in the IFRIC 2012 and IFRIC 2013 did not arrive to any conclusion with regards to the presentation of cash inflows relating to government grants in the statement of cash flows. (EY, 2024) notes that during this discussion the staff were of the view that government grants were a source of finance to an entity and should therefore the cash inflow should be classified as under the financing activities. However, in the later discussions it was concluded that cash received as a government grant should be presented as an operating cash flow since a grant is not a borrowing activity because there is no expectation of returning the grant to the provider of the grant. Therefore (EY, 2024) notes that due to unavailability of clarifications, it is inevitable that corporates would have different practices.

3- Difference interpretations on cash and cash equivalents

IAS 7 (6) states that cash comprises of cash on hand and demand deposits whereas cash equivalents are short-term, highly liquid investments that are already readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

IAS 7(7) also states that the following about cash equivalents:

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investments of other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualified as a cash equivalent only when it has short maturity of, say, three months or less from the date of acquisitions. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares within a short period of their maturity and with a specified redemption date.

According to (EY, 2024) there can be different interpretations on cash and cash equivalent definitions which could cause diversities in practice amongst preparers on what can be classified as cash and cash equivalents. Furthermore, (EY, 2024) highlights that even though IAS 7 does not provide a definition of demand deposits, they are considered to be commonly understood in practice. The amounts not classified as cash because they do not qualify as demand deposits could still qualify as cash equivalents. In the IASB's third agenda consultation respondents were of the view that there should be a review of the definition.

As highlighted in the roundtable session, the requirement of what should be considered cash and cash equivalents does not result in the useful information. It was pointed by respondents that some of them considered the requirements to be too restrictive on what can be considered cash and cash equivalents. For example, some do not find it useful that six months term deposits are not considered cash equivalents as these assets can be easily converted into cash and their exclusions from the statement of cash flows does not align with the entity's liquidity management approach. Thus, the current requirements do not result in information being useful to assess management's cash management practices.

The Emergence of Cryptocurrencies

Cryptocurrencies were discussed in the IFRIC 2019 meeting and in that meeting IFRIC remarked that there is a wide range of crypto assets. However, in the discussion IFRIC considered a subset of the crypto assets which it referred to as cryptocurrencies. It characterized the cryptocurrencies in the following manner:

- A digital or virtual currency recorded on a distributed ledger that uses cryptography for security.
- Not issued by a jurisdictional authority or other party.
- Does not give rise to a contract between the holder and another party.

The Committee remarked that it was not aware of any cryptocurrencies that were used as a medium of exchange and as a monetary unit in the pricing of goods and services to an extent that it becomes a basis on which related transactions are measures and recognised in financial statements. The Committee concluded that cryptocurrencies currently do not have the characteristics of cash (IFRIC, 2019).

According to (EY, 2024), currently the volume of transactions in which cryptocurrency is used as a medium of exchange is still low and there are certain crypto assets which are still not used as a medium of exchange. The potential implications would be in the future periods where holders of cryptocurrencies might have to consider as to whether the cryptocurrencies could be a medium of exchange and a "unit of account" to an extent that it could be a basis of recognising and measuring the related transactions in financial statements.

Exclusion of non-cash transactions

According to IAS 7 (43) investing and financing transactions that do not required the use of cash or cash equivalents are to be excluded from the statement of cash flows. These transactions should be disclosed somewhere in the financial statements in a way that provides all relevant information about the investing and financing activities.

Panel members in the EFRAG roundtable argues that excluding all non-cash transactions from the statement of cash flows does not result in comparable information. For instance, the purchase of an asset (or a business) in exchange for own shares has the same economical substance as first selling own shares and then purchasing an asset with the cash received. They concluded that the two transactions should be presented in the statement of cash flows.

They also highlighted that in addition to not providing comparable information, the exclusion of non-cash transactions from the statement of cash flows makes the information less relevant and distorts the objectives/purpose of the statement. For this case, not including the above-mentioned non-cash transaction (acquisition of an asset by means of own shares) could affect the objective of understanding an entity's business model and assessing management's general performance.

4- Manipulation of the Statement of Cash Flows

As per our observation of the roundtable sessions, there was no discussion with regards to manipulation of the statement of cash flows. Hence, there was a need of going through the academic literature to find if there were discussions on this issue.

(Broome, 2024 & Tergesen 2002), argue that the statement of cash flows can also be manipulated by managers other than presentation errors. This manipulation is done through cash flow classification and timing of cash collections and payments.

As (Number, 2006) points out, the management of a company may manipulate the net operating cash flows to mislead shareholders and investors about the actual performance of the entity. (Dechow & Skinner, 2000) remark that management may manipulate financial statements to meet or exceed financial analyst's expectations, increase the company's share price and increase management incentives related to compensations. As (Lee, 2012) points out, there are four reasons why management would seek to manipulate the statement of cash flows: (i) financial distress, (ii) long-term credit rating, (iii) existence of analyst cash flow forecasts, (iv) relationship between valuation and reported operating cash flows.

Manipulation of the statement of cash flows is done by reporting certain items of cash inflows in the investing and financing activities as operating activities and classifying certain items of cash outflows or operating activities into the investing and financing activities. [Our understanding as Zielke after going through relevant literature and material related to SCF manipulation].

Therefore, manipulation practices can affect the objective of the statement of cash flows in providing information to users for identifying earnings management (assessment of accruals). Hence, the IASB could look into the possibility of addressing this issue.

Example of Cash Flow Statement Manipulation

WorldCom- overstating of operating cash flows

(Romero & Berenson, 2002) in their study report that WorldCom was found to be overstating its operating cash flows by more than §3.8 billion over a period of five quarters where the management classified operating activities such as basis network maintenance as investing activities.

According to the article published by the (New York Times) in 2002, WorldCom board had fired Mr. Sullivan after identifying a strategy where operating costs such as the basic maintenance had been booked as capital investments – an "accounting gimmick" that enabled WorldCom to hid expenses, inflate its cash flows and report profits instead of losses.

5- Additional Disclosures

During the roundtable session organized by EFRAG with respect to the statement of cash flows project, panel members of the corporate roundtable in particular highlighted that it would be impossible to address all of the issues related to the statement of cash flows and rather than focusing on the review of the statement of cash flows, it would be better to give directives to companies in order to provide additional disclosures which would ensure that investors obtain the relevant information that they require. In the follow up question raised by the EFRAG team to the panel members in the roundtable session conducted with valuators, one of the panel members (a valuer) also pointed out that it would be valuable for corporates to disclose additional disclosures rather than regulatory bodies and relevant stakeholder allocating more resources towards the reconstruction of the statement of cash flows.

This was also mentioned by a preparer and former equity analysts stressing the importance of corporates disclosing additional disclosures as this would provide information both for the internal controls of an entity as well external guidance to investors as they would be able to understand the cash flows position of the entity.

Therefore, this section deals with a discussion of the additional disclosures in addition to the statement of cash flows as recommended and opined by panel members of the roundtable sessions (preparers and users) and as presented in the relevant manuals relating to the either the IASB or FASB.

Additional Disclosure – Breakdown of Capex

It was a highlighted by a panel member i.e. a preparer of the corporate roundtable session that investors were interested in information explaining the breakdown of Capex such as how it has been spent and how it has realized growth for the entity as investors would be able to track and understand its progress. This was also reckoned by another preparer representing a big pharma company where he highlighted that his company conducted a peer study and found out that their competitors in the market disclosed information relating to the breakdown of their Capex (PPE) in the footnotes. A preparer also opined that companies should provide additional disclosures of their Capex so that users are able to understand between the portion of Capex allocated for maintenance and growth and how much of it has been capitalized. In the roundtable session held with valuators, they highlighted that information pertaining to growth Capex was important for valuing businesses.

The Financial Reporting Council in 2012 conducted a project related to cash flow statement reporting with respect to operating and investing cash flows. For the investing cash flows, investors remarked that the gross amounts of Capex and disposal of assets should be disclosed and a separate amount of tangible and intangible assets such as software should be disclosed. They also wanted to see information on the breakdown of maintenance and growth Capex. They deemed that the growth Capex disclosure was important as it affects development and net debt. Therefore, the concern was that they wanted this information to be provided on the face of the statement of cash flows instead of being disclosed (FRC, 2012).

Additional Disclosure – Information on Cash Flows from Operating and Non-Operating Assets

A panel member (valuator) remarked that from a valuation standpoint, it is very important to understand the sources of an entity's cash flows as this ensures the identification of an entity's asset and liability mismatch. When the sources of cash flows are known, it becomes inevitable that the duration of assets and liabilities become known. The issue prevalent at the moment with the statement of cash flows is that a user is not able to distinguish between the cash flows arising from operating assets and non-operating assets. This is important for the understanding of an entity's sustainable earnings power. Therefore, it would be valuable and useful for corporates to provide information pertaining to cash flows related to operating assets and cash flows related to non-operating assets respectively.

Additional Disclosure – A store of future value

A panel member (valuator) added that it would also be helpful if entities provide additional disclosures pertaining to "a store of near liquid assets" which gives an explanation of future investments to be undertaken and potential dividends. He added that for valuers "a store near liquid assets" is different from cash and is the surplus that could be distributed to shareholders.

Additional Disclosure – Expected Future Cash Flows

One of the preparers at the corporate roundtable remarked that as additional disclosures, investors wanted to obtain information pertaining to the expected future cash flows of their business from normalized business activity going into the future excluding any incidentals. She noted that this practice was against the IFRS norms, but investors insisted on it.

Additional Disclosure – Working Capital Changes (WCC)

The Financial Reporting Council (FRC) in their operating and investing cash flow project reported that investors prefer a separate disclosure of the changes in working capital as this would enable them to understand which components of the working capital influence the overall working capital change and which of those components of the working capital are managed by the company. They also emphasized that large changes of working capital components should be shown separately. It was also noted that there was no standard definition of working capital (also highlighted by a preparer) and as a result, that companies disclose their own definition of working capital. One of companies in the study noted that by having a separate disclosure of the movements in working capital components, users would be able to better understand the performance of the operating cash flows of an entity. (FRC, 2012).

Additional Disclosure – Intercompany cash flows

In one of the roundtable sessions, a user highlighted that users would like to get more information on 'upstreaming of cash flows. For instance, in the case where significant investments are made without additional cash flow from financing activities, users would want to know which part of the group was financing this investment. In addition, users would want to know where in the group the cash is stuck as cash held by one company in a group may not be available for another entity in the group.

6- Conclusion

The discussion in this report has focused itself in highlighting the various issues with the IAS 7 statement of cash flows of corporates. As discussed in the objectives and uses part, the statement of cash flows has its own uses as described by the standard itself.

As stated in the IAS standard, cash flow information of an entity is useful in providing users of financial statements a basis of assessing an entity's ability to generate cash and cash equivalents and the needs of the entity to utilise the cash flows (IAS 7). It also highlights that the benefit of the statement of cash flows when used with the other financial statements, provides users with information that can be used to evaluate the changes in net assets of an entity, the financial structure (liquidity and solvency) and the ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. (IAS 7(4).

Hence, the statement of cash flows is an important financial statement, and we cannot ignore it. We also observed the opinions from panel members of the various EFRAG Working Group Meetings together with the discussions of the roundtable sessions where a broader spectrum of statement of cash flows stakeholders such as preparers, auditors, credit analysts, equity analysts, investors, academics and other users explained the various uses of the statement of cash flows but more so on the prevailing issues with the current IAS 7 statement of cash flows.

The issues raised means that preparers have to allocate additional resources to provide additional disclosures so that users such investors can obtain the necessary information of companies to perform and effective financial analysis.

As highlighted by the Financial Reporting Council (FRC, 2012) in their report pertaining to the project of operating and investing cash flows, the reporting of cash flows in the statement of cash flows was seen as important to equity valuation.

Therefore, we believe that due to the fast-changing business and economic environment, there would be instances where it would be challenging to classify certain transactions in the statement of cash flows. This means that the classification issue would remain a challenging element with the statement of cash flows.

Active frequent engagements through cooperation should be organized where regional accounting bodies together with the international accounting bodies work together to understand the needs of both preparers and users of the statement of cash flows.

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The Issues of the Statement of Cash Flows of Financial Institutions (Banks and Insurance Companies)

This chapter looks at the issues of the statement of cash flows of financial institutions with specific reference to banks and insurance companies.

However, it is to be noted that the lack of relevance of the statement of cash flows together with its issues is not only limited to banks and insurance companies but also to all other types of financial institutions which have an Asset and Liability Management process. The statement of cash flows of leasing companies should also be taken into consideration when discussing the issues of the statement of cash flows of financial institutions (ANC & DRSC 2016).

During the phase of collection of input from the relevant sources for writing this report, it was evident that the discussion that took place in the financial institutions' roundtable revolved around banks and insurance companies. More so, even the opinions contributed by the panel members with respect to financial institutions in the other roundtable sessions i.e. corporate, users (analysts) and academics circled related to banks and insurance companies.

Henceforth, the discussion in this chapter will concentrate on the prevalent issues of the statement of cash flows of banks and insurance companies using the following sources:

- Academic Literature
- Input collected from the roundtable session and EFRAG Working Group Meetings. A special reference is made to the financial institution roundtable session.
- The EFRAG 2015 Discussion – The Statement of Cash Flows Issues for Financial Institutions and the follow-up comments addressed by the regional accounting standard setters.
- Discussion conducted by International Accounting Standard Setters on the subject matter i.e. IASB and FASB.
- Manuals/periodicals of Accounting Firms.

Therefore, to discuss the subject matter we have bifurcated it into two parts namely:

Discussion 1 – What are the issues of the statement of cash flows of banks?

Discussion 2 – What are the issues of the statement of cash flows of insurance companies?

Discussion 1 – What are the issues of the statement of cash flow of Banks?

This section deals with the discussion pertaining to the issues of the statement of cash flows of banks. As a continuation of the first phase of this proactive research project where we discussed the objectives and uses of the statement of cash flows for both corporates and financial institutions (banks and insurance companies), this part focuses on highlighting the various issues of the statement of cash flows of banks since it does not provide relevant information. The statement of cash flows does not provide relevant information statement of cash flows of banks as observed and understood by users of primary financial statements is of limited use (value relevance) as it does not provide relevant and valuable information in the assessment of the financial performance of a bank.

As emphasized by the panel members of the financial institution roundtable together with those who echoed their views in the EFRAG Working Group Meetings (FIWG, IWG & FR TG/UP), reporting of regulatory capital requirement and liquidity risk disclosures for banks appeared to be the shared consensus. Hence, they shared their opinions about the various probable issues of the statement of cash flows of banks.

According to the EFRAG 2015 Discussion Paper (EFRAG 2015 – the statement of cash flows Issues for financial institutions), which pointed out that there is very few academic research on the issues of the statement of cash flows of financial institutions.

As per a panel member of the financial institutions' roundtable, (an auditor-bank) noted that the statement of cash flows does not link to any KPIs or key regulatory parameters, especially for banks.

An academic at the academic panel meeting noted that the statement of cash flows lacks sufficient information on risks from unrealised profit as well as disclosures of structured bonds that are not traded. We as Zielke Research Consult being independent of EFRAG's view on the subject matter are of the view that much of the academic research on the statement of cash flows discussing issues is related to corporates, and the amount of academic research for discussing the issues of the statement of cash flows with respect to financial institutions (banks and insurance companies) is relatively limited compared to corporates.

The issues discussed in this section are primarily based on the financial institution roundtable session as panel members representing preparers and users of financial statements shared their views about the practical issues of the statement of cash flows of banks and insurance companies. This provided a starting point for us to link the views with the most relevant academic literature relating to the statement of cash flows and financial institutions. The other roundtable session also provided us with some relevant inputs pertaining to the subject matter. In addition, the EFRAG 2015 Discussion Paper also provided us with a basis of understanding the issues relevant to financial institutions as the paper's discussion was based on the input received from the comment letters of regional accounting standard setters.

Lastly, the comment letters to the IASB Discussion Paper – Preliminary Views on Financial Statement Presentation, 2008 also provided us with an understanding to develop the issues that have been discussed in the next sections.

Liquidity Information

Academic Literature:

It is to be noted that there is very scant academic research available on the topic of banks' statement of cash flows and its inability of providing information pertaining to liquidity. As (Klumpes et al., 2009) point out; the available literature on banking and liquidity has been focused on either macroeconomic analysis without the actual analysis of the relevant financial statements. They argue that the reason of the lack of emphasis on banks' statement of cash flows is due to the fact that a greater significance is put on accrual-based accounts because which provides information related to matching of 'specific' portfolios of assets and liabilities. A test was conducted by (Gao et al., 2019) where they found out that banks' statement of cash flows did not have distress-predictive power.

Issue - as highlighted in the EFRAG DP-2015:

The EFRAG DP-2015 remarked that among the issues brought forward by banks in their comment letters as a follow-up to the (IASB Discussion Paper – Preliminary Views on Financial Statements Presentation 2008), was the issue of the irrelevancy of the statement of cash flows in providing information to users for the assessment of liquidity risk as future cash flows of a bank are not only determined on the basis of accounting information but also by a bank's ability to produce future loans together with the appropriate funding. It provides limited information about a bank's liquidity risk exposure (EFRAG DP-2015).

EFRAG Working Group Meeting and Roundtable Sessions:

At the EFRAG FIWG meeting held on 28/042024, some panel members agreed that the banking business model was different from that of corporates and therefore the statement of cash flows of banks does not provide information about liquidity risk disclosures which is one of the primary concerns of the users of banks' statement of cash flows. They also remarked that better risk disclosures about liquidity were important to the users of banks' statement of cash flows. These views were also similarly echoed by the respondents of the EFRAG FR TEG meeting held on [06.06.2023] where a panel member pointed out that banks were already disclosing other regulatory reports that provided liquidity information rather than the information on the statement of cash flows. Users shared the same opinion. A valuator also added that the statement of cash flows of a bank does not provide sufficient information in understanding the liquidity position of a bank due to a mix of financial products used in their financing and operating activities. It does not provide a clear distinction related to the liquidity issues of the financing component and liquidity issues of the operating component.

This discussion on the subject matter continued in the financial institution roundtable where the banking industry stakeholders i.e., a preparer, an auditor, an academic, and a user highlighted that the statement of cash flows of banks is not effective and does not provide liquidity information to users. A preparer remarked that users did not use it in their analysis because a bank's value creation transactions such as loans are not based on cash as when a loan is sanctioned the money flows directly into the customer's current account and is also paid from the current account – this argument was also echoed by a user. It was noted that the demand deposits would bring up the question of a bank's liquidity but since this information is provided in the liquidity risk disclosures, the statement of cash flows of banks should be removed as a reporting requirement. This argument of removing the statement of cash flows was also supported by an academic. Lastly, a preparer highlighted that there could be a possibility of seeing regulators as potential users of banks' statement of cash flows.

Issue -as discussed by regional and international accounting standard setters

As follow-up comments to the EFRAG DP-2015, various European regional accounting standard setters opined their understanding of the issues of the statement of cash flows of financial institutions. The AUTORITE DES NORMES COMPTABLES (ANC) of France remarked that users (analysts) do not use the statement of cash flows in the assessment of the liquidity position of banks as it does not provide sufficient information and therefore, they tend to use other prudential disclosures to find relevant information. (e.g. Pillar III of Basel agreement). The body also stated that preparers of bank statement of cash flows do not use the statement as a tool for monitoring liquidity risks of banks. The Dutch Accounting Standard Boards also pointed out about the lack of liquidity information in banks' statement of cash flows as the sources and background of the changes of a bank's total cash position due to financial risk management is currently not reflected in the statement of cash flows.

Thus, the identified issue of results into the statement of cash flows of banks not being able to meet the objective/use of providing information for liquidity assessment of a bank.

Classification into operating, investing, and financing activities is not useful

Academic Literature:

The categorizing of activities into either operating, investing and, financing is not useful for banks' statement of cash flows as compared to non-financial firms. A bank's core operations are financing and investing where the operative product is cash unlike non-financial firms. Usually, banks aim at lending long and borrowing short which is associated with different maturity periods. These various maturity periods result in different amounts in cash flows thus making it difficult for users to assess and understand where the operational activity starts and end, hence making the classification of activities into operating, investing and financing ineffective (Torfason, 2014). According to (Weiss et al., 2007) the case of the statement of cash flows for banks is different to that of non-financial companies. The core-operations of a bank is divided into on-balance sheet and off-balance sheet activities. The off-balance sheet activities which are the fee-based activities for the services provided that do not create an asset or liability and appear on the operating section of the statement of cash flows. The on-balance sheet activities such as (i) managing depositor's account (ii) lending money to customers and (iii) trading in securities results into the issues with the statement of cash flows of banks. They further note that customer deposits are classified under financing activities whereas loans to customers appear in the investing section. As a result, the "cash provided by operations" is meaningless and thus, the categorization of cash flows into operating, investing and financing activities for banks is not useful to users (Weiss et al., 2007).

In a study conducted by the Georgia Tech Financial Analysis Lab on a survey of fifteen of the largest independent and publicly-trade U.S. companies commercial banks, it was found that the banks were consistent in the classification of their cash flows. However, the study reported on the effects of important non-cash transactions on operating cash flows. These transactions do not affect the current cash flows but have a significant effect on future reported operating cash flows and therefore are presented as footnotes to the statement of cash flows. For example, a transfer of investment that is held as available for sale to a trading classification is presented in the footnotes to the statement of cash flows as it would have no effect on the current cash flow. But once this investment is sold, it would increase the operating cash flow. If at all the sale of investment that is not transferred remains as available for sale securities, this would increase cash flows from investing activities. Therefore, this questions the value relevance of operating cash flows for users in conducting their financial analysis (Mulford & Comiskey, 2009).

Issue - as highlighted in the EFRAG DP-2015:

The EFRAG DP-2015 highlighted that analysts pointed out that the categorization into operating, investing and financing was not useful for banks and that they focused more on the changes of specific items in the balance sheet. The DP also remarked that banks argued that since the assets and liabilities of financial institutions (for this case banks) are 'fungible' and the balance sheet items being interrelated, the presentation into operating, investing and, financing would not improve the financial statements of banks (EFRAG-DP 2015).

Issue -as discussed by regional and international accounting standard setters

The German Accounting Standards Committee (DRSC,2016) and the German Cooperative and Raiffeisen Confederation (DGRV, 2016) in their comment letters to the EFRAG DP-2015 also opined that the classification into operating, investing and financing for banks was not useful.

Hence, the issue discussed here makes it difficult for the statement of cash flows of banks to provide information for explaining the business model of a bank due to the classification into operating, investing and financing activities of the cash flows being not meaningful. This is because the nature of a bank's cash flows is different to that of non-financial entities.

The issue of direct vs indirect method

According to (Torfason, 2014) most banks use the indirect method of preparing the statement of cash flows which already makes the connection to the actual cash transactions more difficult. He argues that the indirect method demands more use of net cash flows which results in less information provided by the statement of cash flows. For banks, the cash flows associated between customers of banks can be netted out at the central banking level. This in turn reduces the information that a bank's statement of cash flows can provide. This was also reported in the paper prepared by the joint FASB and IASB working in group (FASB &IASB, 2010) where financial analysts of banks reported that they did not use the indirect method of the statement of cash flows for their assessment.

(Klumpes et al., 2009) remark that banks use the provision of the IAS 7 which allows key operations to be netted off. This netting off results in the application of the indirect method of preparing the statement of cash flows. Their study conducted a survey of UK and European banks and concluded that most of the banks in those regions reported their "operating assets" and "operating liabilities" flows on a net basis. This approach of the indirect method meant that only the net change of the core business flows in a reporting period were available. Items such as gross flows in loans and repayment, deposits and withdrawals, debt issues, redemptions are not available in the statement of cash flows as well as in the notes to accounts.

Issue - as highlighted in the EFRAG DP-2015:

This issue was discussed in the EFRAG DP-2015 where it highlighted the views expressed by banks that the direct method does not provide relevant information for users as regards to the change of a bank's net assets, the financial structure (liquidity and solvency) and the ability to affect the amounts of timings of cash flows. The reason being is that banks conduct large quantities of cash transactions daily which usually are not under the control of the bank as they are undertaken by customers of the bank who decide on the amount and timings of payment and receipt.

Issue -as discussed by regional and international accounting standard setters:

IAS 7(19(a) encourages entities to report their cash flows from operating activities using the direct method as it argues that the direct method provides information which may be useful for estimating future cash flows which the indirect method does not provide. According to paragraph (3.80) of the Discussion Paper – Preliminary views on Financial Statements Presentation, it was noted that the board proposed by requiring a direct method of cash flow presentation though it acknowledged users' interest in the reconciliation of information the indirect method provides. The argument brought forward was that, that the reconciling information '"is not a valid substitute for information about operating cash receipts and payments (IASB DP – 2008).

We assessed the various comment letters that were shared to us by EFRAG following their 2015 Discussion Paper to check whether the issue of direct and indirect method of banks' statement of cash flows was raised. The comment letters at our disposal did not explicitly discuss about the direct and indirect method. Hence, we took a further step by assessing the comment letters of banks submitted to the IASB in 2009 following the 2008 Discussion Paper – Preliminary Views on Financial Statement Presentation (because of the IASB and FASB joint project) to check whether this issue was commented banks, banking associations or international institutions regarding banking. After analysing the 228 comment letters, the following are the comment letters that are specifically relevant to the issues of direct vs indirect method of banks' statement of cash flows:

U.S. Bancorp in their letter to both the FASB and IASB commented on the issue of direct vs indirect method:

We do not believe that the direct method of presenting operating cash flows provides superior information to the indirect method. We do not agree that the direct method is more consistent with the proposed cohesiveness and disaggregation objectives. (CL 2009 no. 144:19)

Morgan Stanley in their letter to the IASB commented on the issue of direct vs indirect method:

We are not convinced that the arguments in support of presenting the statement of cash flows using the direct method are strong to justify the significant additional costs of collating the necessary information. (CL 2009 no. 163)

Deutsche Bank in their letter to the IASB commented on the issue of direct vs indirect method:

We do not believe that the direct method is meaningful or useful for users of financial statements of banks as it does not satisfy the main benefits of cash flow statements. To go one step further, it is questionable whether a statement of cash flows, whether direct or indirect is indeed useful at all in analysing financial statements of banks. Paragraph 3.77 of the DP states that many users attempt to construct a direct method of cash flow statement from other information in financial statements but in our view, we do not expect that users of a bank's statement of cash flows would attempt this as the information that they will obtain would be of little benefit or not benefit, in fact we believe the "gross up" of operating cash flows would obscure any benefit of the indirect method currently being used. It should be noted that internally, the management of a bank does not view the statement of cash flows as an indicator or tool to assess the bank's liquidity and analyse the bank's ability to generate cash and create value for shareholders and therefore it is questionable how much information external users derive from them. *For a bank, the direct method is not consistent with the cohesiveness objective because there is little relationship between certain types of operating assets and liabilities and operating income and expenses*. (CL 2009 no. 168:1)

BNP Paribas in their comment letter to the IASB commented on the issues of direct vs indirect method:

We believe that the cash flow statement, whether direct or indirect format, is meaningless for financial institutions. Direct method cash flow statements are very difficult to produce, which is today evidenced by the fact that there is hardly any company that produces a pure direct cash flow statement, let alone an industry that used it as its reporting standard. The board has often referred to Australia, when speaking about a direct cash flow statement which in reality produce a direct/indirect cash flow statement, because the direct cash flow statement cannot be/is very hard to produce. Theoretical ideas need to be thought through to their usefulness and their cost benefit, of which, the direct cash flow does not provide a benefit. In reality, the users of banks' financial statements do not referee the indirect cash flow statements. Although indirect cash flow statements have been previously produced, they have not been shown to be of value. Therefore, indirect cash flow statements for financial institutions should be optimal. (CL 2009 no. 174:1)

Therefore, the issue discussed here makes it challenging for users of the statement of cash flows to explain the various movements of cash as highlighted by the Accounting Standards Committee of Germany (DRSC, 2016) in their comment letter to EFRAG 2015 Discussion Paper. As the indirect method which is widely used by banks does only reports the core business flows, the other flows which are mentioned in the above paragraphs are not presented, thus implicating that a full picture of cash movements of a bank are not reflected.

Definition of Cash and Non-Cash Items

Academic Literature:

It must be noted that due to the limited studies available about financial institution's bank statement of cash flows, it was challenging in searching for information about the definitions of cash and non-cash items in the context of the issue of financial institutions statement of cash flows. However, we found some academic literature which discuss the subject matter:

According to (Torfason, 2014), the unclear definition of cash and non-cash items of banks in the context of their statement of cash flows creates various reporting problems. As cash is a commodity in a bank unlike for corporates, the cash flows in and out of a bank to other banks which also entail netting out of these flows. For example, when a bank creates a new credit, it cannot be separated from the existing cash in the system of account. Also, overdrafts are treated differently as either cash equivalent or not.

Issue -as discussed by regional and international accounting standard setters

The Accounting Standards Committee of Germany (DRSC, 2016) and the German Cooperative and Raiffeisen Confederation (DGR, 2016) shared the same opinion as regards to the presentation of cash and cash equivalent for banks in their statement of cash flows and that it was not meaningful due to volatility of a bank's cash and cash equivalents. The Accounting Standards Committee of Germany (DRSC, 2016) did not agree with the claim made by EFRAG in the Discussion Paper that (i) financial institutions can easily access markets to trade their assets and (ii) the length needed to convert these assets is much shorter. They argued that (i) selling of an asset by a financial institution could be a liquidity obtaining strategy which is rarely applied, (ii) the asset side of balance sheet are stable and (iii) the liability side of the balance sheet is of greater importance together with the ability to raise liquidity on favourable condition.

Therefore, the issue discussed here similarly relates to the implication of the direct vs indirect method as it is also linked to the objective/use of the statement of cash flows not being able to provide information pertaining to the various movements of cash as remarked by the Accounting Standards Committee of Germany (DRSC, 2016).

Discussion 2 – What are the issues of the statement of cash flow of Insurance Companies?

This section deals with the discussion pertaining to the issues of the statement of cash flows of insurance companies. As a continuation of the first phase of this proactive research project where we discussed the objectives and uses of the statement of cash flows for corporates and financial institutions (banks and insurance companies), this part focuses on highlighting the various issues of the statement of cash flows of insurance companies. The statement of cash flows of insurance companies as observed and understood by users of primary financial statements is of limited use (value relevance) as it does not provide relevant and valuable information to users in the assessment of the financial performance of insurance companies.

As emphasized by the panel members of the financial institution roundtable together with those who echoed their views in the EFRAG Working Group Meetings (FIWG, IWG & FR TG/UP), reporting of liquidity risk disclosures for insurance companies appeared to be the shared consensus. Hence, they shared their opinions about the various probable issues of the statement of cash flows of insurance companies. It is to be noted that the input received with respect to insurance companies was less compared to the banks.

A panel (insurance auditor) member, of the financial institutions' roundtable noted that for insurance companies, liquid reserves such as traded bonds are commonly held by insurers which does not meet the definition of cash.

Our opinion is that, that the EFRAG 2015 Discussion Paper did not discuss the issue of the statement of cash flows prevalent with insurance companies. Some of the comment letters received from the regional accounting standards and insurance bodies criticized the various alternatives proposed in the Discussion Paper (Association of German Banks – VOB), while other such as the Insurance Europe acknowledged the limited relevance of the statement of cash flows of insurance companies. The German Insurance Association (GDV, 2016) also highlighted that there was no specific mention to insurance companies in the Discussion Paper and pointed out for the abolishment of the statement of cash flows of insurance companies.

In their comment letter to the IASB following the IASB FASB Discussion Paper – Preliminary View of Financial Statement Presentation, (Allianz, 2009) highlighted that analysts did not use the statement of cash flows but used the information provided in the MCEV disclosures. MCEV – Market Consistent Embedded Value is a measure of the consolidated value of shareholder's interests in the covered business whereas Group Market Consistent Embedded Value (Group MCEV) is a measure of the consolidated value of shareholders' interests in covered and non-covered businesses (CFO Forum, 2009). They believed the statement of cash flows of insurance companies whether direct or indirect has limited value to help users predict future cash flows. This was also reiterated by (Insurers of Europe, 2009) in their comment letter to both the IASB and FASB where they highlighted that the value relevance of insurer's statement of cash flows was low as insurer's products have a life cycle which is greater than one year. Hence, a statement of cash flows whether direct or indirect covering one year would not provide users of financial statements useful information. They stressed that users of insurer's financial statements usually require additional information that distinguishes the cash flows of policyholders and that of shareholders in order to predict future cash flows and therefore this information is provided outside the financial statements.

Additional Disclosures Relevant for Financial Institutions (Banks and Insurance Companies)

The following are the additional disclosures which have been suggested for banks and insurance companies through the following sources:

- Comment Letters from regional and international accounting standard setters, banking and insurance bodies following the EFRAG DP 2015.
- Input collected from roundtable sessions (particularly financial institution roundtable) and EFRAG Working Group Meetings.

It is to be noted that in the first part of this proactive project, we already discussed the alternative reporting requirements for financial institutions i.e., banks and insurance companies from the input that was received in the financial institution roundtable. Academic literature also discussed these alterative requirements.

However, the focus here is to discuss the additional disclosures to the statement of cash flows of banks and insurance companies, as we now have an understanding that the current IAS 7 statement of cash flows prepared under the direct method and indirect method is less useful for users.). Nevertheless, as banks and insurance companies are still mandated to prepare the statement of cash flows, preparers have also been preparing additional disclosures which have been useful to users. Various regional and international bodies related to insurance and banking accounting have also proposed disclosures which is believed could provide useful information to users.

Time Series of a Ratio- Asset Encumbrance Ratio

The Accounting Standards Committee of Germany (DRSC, 2016) in their comment letter to EFRAG's DP 2015 highlighted that they acknowledged the disclosures related to banks as already mandated by IFRS 7 but added that banks could enhance their financial reporting by providing additional disclosures with respect to liquidity and liquidity risk. The DRSC questioned the static disclosures of a bank's liquidity information as a bank's liquidity can fluctuate in short periods of time. Users would not obtain any useful information to assess the liquidity position of a bank and therefore they proposed disclosing a time series of a particular ratio (the asset encumbrance ratio). This would provide useful information as users would be able to observe trends and developments making assessment of a bank's liquidity position informative than reporting it at a single point. According to (EFRAG DP 2015), disclosures pertaining to encumbered and unencumbered assets provide additional insight into the liquidity position of banks.

Cash Balance Sheet

The "Cash Balance Sheet" as an additional disclosure to the statement of cash flows in banks has been a practice observed by French and some European banks as part of their financial reporting. The AUTORITE DES NORMES COMPTABLES (ANC, 2016) in their comment letter to the EFRAG 2015 DP highlighted that the "Cash Balance Sheet" provides additional information to financial statement users which explains the funding structure of a bank as well as the key sources of funding i.e., financing vehicles, capital markets, equity, discretionary wholesale secured funding among others).

It is termed differently among banks ("Funded balance sheet", "Funding relationship", or "Funding sources and uses"). The fundamental of the "cash balance sheet" is structured based on 'adjusted IFRS balance sheet items' and usually the bank provides notes on the methodology which describes how the adjustments are conducted e.g. assets and liabilities compensation or the reclassification of funding sources (ANC, 2016). This was also reiterated by the Dutch Accounting Standards Board (DASB, 2016) in their comment letter to the EFRAG DP 2015 where they also remarked that information concerning the sources of financial institutions' total cash position was an important element of information that could provide valuable information to users.

For clarity of understanding, we have attached examples of the concept "cash balance sheet" reported by some of the European banks as part of their additional disclosures in Appendix (1).

Liquidity Risk Information with reference to IFRS 7: Financial Instruments – Disclosures and IFRS 17: Insurance Contracts

The panel members in the financial institutions (banks and insurance companies) roundtable all noted that liquidity risk information was important for both banks and insurance companies as their statements of cash flows were of limited use. A user highlighted that the balance captured on the balance sheet is financed through market transactions. He highlighted that banks are already providing good disclosures such as the IFRS 7 – Financial Instruments: Disclosures. This was also agreed by a bank auditor. An insurance auditor highlighted that insurance companies already disclose liquidity related disclosures under Solvency II which has already been discussed in the first part of this proactive research project. He also emphasized on the IFRS 17 (132) – Insurance Contracts liquidity risk information which is relevant for insurance companies.

Providing Information on Free Surplus (as mentioned in EFRAG DP 2015)

The EFRAG DP 2015 highlighted that the provision of information pertaining to the breakdown of free surplus would be useful for analysts. The comments were made in the EFRAG Insurance Accounting Working Group (IAWG) and Financial Instrument Working Group (FIWG) where the panel members pointed out that some of the analysts were interested in how the free surplus was used i.e., how much is used to pay for dividends, how much to meet central costs and how much is invested in new businesses.

Information pertaining to duration of assets and liabilities

Valuators noted that for insurance companies, information about the sources of cash flows is important to users which enables them to understand the duration of assets and liabilities. Currently the statement of cash flows does not provide this information.

Conclusion

After highlighting the various concerns from the limited available literature pertaining to the statement of cash flows of financial institutions (banks and insurance companies), the various comment letters by regional and international accounting/banking/insurance bodies, the discussion in the EFRAG DP 2015 together with the input collected from the various roundtable and EFRAG Working Group Meetings, it is clearly evident that the statement of cash flows of both banks and insurance companies is of less value relevance for users of banks and insurance financial statements due to their different business model compared to the traditional corporates.

As it has been noted, disclosures pertaining to regulatory capital and liquidity risk disclosures are most important for banks and insurance companies which according to the discussion in this part, both banks and insurance companies do provide this information through additional disclosures outside the primary financial statements.

Our findings also suggest that there is limited academic research within the context of financial institutions i.e., banks and insurance companies and as per some comment letters received from the regional and international accounting /banking/insurance bodies, the discussion of financial institutions should not only be based on banks and insurance companies but extended to any type of financial institutions which has an asset and liability management operation. As suggested by one the regional bodies, leasing companies should also be included in the discussion.

There have been mixed opinions over the statement of cash flows of banks and insurance companies where two perspectives have been raised one being the complete abolishment of the statement of cash flows and other being the retainment of the statement of cash flows of banks and insurance companies.

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EFRAG Academic Panel Meeting 31.10.2023

EFRAG Discussion Paper 2015 – Issues of the statement of cash flows for financial institutions

EFRAG Financial Institutions Roundtable session

EFRAG FIWG Meeting 26.05.2023

EFRAG FR Board Meeting 7.11.2023

EFRAG FR TEG & EFRAG UP Meeting 06.60.2023

EFRAG FR TEG Meeting 30.10.2023

EFRAG IAWG Meeting 06.09.2023

EFRAG session with the IVSC 07.02.2024

EFRAG Users and Academic Roundtable session

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Appendix (1)

1- Funding Sources and Funding Uses – HSBC Holding plc

Funding sources

(Audited)

	2023 $m	2022[1] $m
Customer accounts	**1,611,647**	1,570,303
Deposits by banks	**73,163**	66,722
Repurchase agreements – non-trading	**172,100**	127,747
Debt securities in issue	**93,917**	78,149
Cash collateral, margin and settlement accounts	**85,255**	88,476
Liabilities of disposal groups held for sale[2]	**108,406**	114,597
Subordinated liabilities	**24,954**	22,290
Financial liabilities designated at fair value	**141,426**	127,321
Insurance contract liabilities	**120,851**	108,816
Trading liabilities	**73,150**	72,353
– repos	**12,198**	16,254
– stock lending	**3,322**	3,541
– other trading liabilities	**57,630**	52,558
Total equity	**192,610**	185,197
Other balance sheet liabilities	**341,198**	387,315
At 31 Dec	**3,038,677**	2,949,286

Funding uses

(Audited)

	2023 $m	2022[1] $m
Loans and advances to customers	**938,535**	923,561
Loans and advances to banks	**112,902**	104,475
Reverse repurchase agreements – non-trading	**252,217**	253,754
Cash collateral, margin and settlement accounts	**89,911**	82,984
Assets held for sale[2]	**114,134**	115,919
Trading assets	**289,159**	218,093
– reverse repos	**16,575**	14,798
– stock borrowing	**14,609**	10,706
– other trading assets	**257,975**	192,589
Financial investments	**442,763**	364,726
Cash and balances with central banks	**285,868**	327,002
Other balance sheet assets	**513,188**	558,772
At 31 Dec	**3,038,677**	2,949,286

HSBC Holdings plc Annual Report and Accounts 2023

2- Funding structure and funding relationships – Barclays PLC

Assets	2023 £bn	2022 £bn	Liabilities	2023 £bn	2022 £bn
Loans and advances at amortised cost[1]	386	385	Deposits at amortised cost	539	546
Group liquidity pool	298	318	<1 Year wholesale funding	59	73
			>1 Year wholesale funding	118	111
Reverse repurchase agreements, trading portfolio assets, cash collateral and settlement balances	435	412	Repurchase agreements, trading portfolio liabilities, cash collateral and settlement balances	380	370
Derivative financial instruments	257	302	Derivative financial instruments	250	290
Other assets[2]	101	97	Other liabilities	59	55
			Equity	72	69
Total assets	1,477	1,514	Total liabilities	1,477	1,514

Barclays PLC Annual Report 2023

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