This report looks at the statement of cash flows currently prepared as per the IAS 7 “Statement of Cash Flows” by trying to explore the objectives of this financial statement together with its uses, from the perspective of related stakeholders such as Corporates, Users/Academics and Financial Institutions.

The Objectives and Uses of the Statement of Cash Flows

EFRAG Proactive Research Project on the Statement of Cash Flows – Phase 1

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Executive Summary

The objective of the first part of EFRAG's proactive research project on the statement of cash flows (under IAS 7) is to understand the objectives and uses of the statement of cash flows for corporates and financial institutions (banks and insurance companies).

The information related to this part of the project is based on the review of academic literature, input collected from various roundtable sessions organized for corporates, financial institutions, users & academics as well as meetings held by various EFRAG Working Groups such as EFRAG FR TEG, EFRAG User Panel EFRAG, EFRAG FIWG, EFRAG IAWG, EFRAG Academic Panel and EFRAG FRB. In addition, input was also collected from the EFRAG Discussion Paper that was published in 2015, titled "*The statement of cash flows – Issues for financial institutions*".

It must be noted that from the input received at the various roundtable sessions and EFRAG Working Groups, it was observed that the statement of cash flows is relevant and useful for corporates. For financial institutions i.e., banks and insurance companies, concerns were raised especially by the preparers who questioned the relevance of the statement of cash flows for banks and insurance companies, due to the type and nature of their business models. Lastly, it was also observed that the statement of cash flows has very limited relevance to these companies.

Therefore, this report separates the discussion of the objectives and uses of the statement of cash flows for corporates and financial institutions respectively. An additional chapter is dedicated for the alternative reporting requirements for corporates and financial institutions.

The report starts with a general discussion on the definition of IAS 7 – Statement of Cash Flows. Chapter 1 deals with the objectives of the statement of cash flows for corporates. Chapter 2 focuses on the uses of the statement of cash flows for corporates.

Chapter 3 sets forth the objectives and uses of the statement of cash flows for banks and insurance companies. Chapter 4 deals with the alternative reporting requirements for insurance companies, banks and corporates.

Lastly, chapter 5 concludes this part of the proactive research project and lays down the foundation for the second part of the research project which shall be dealing with the issues of the statement of cash flows.

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IAS 7 – International Accounting Standard 7 – Statement of Cash Flows

The objective of the IAS 7 *Statement of Cash Flows* requires entities to provide information pertaining to the historical changes in cash and cash equivalent through a statement of cash flows by classifying the relevant cash flows of a period into operating, investing and financing activities (IFRS – IAS 7, 2023).

The statement of cash flows thus provides stakeholders of financial statements (users) information, as a basis in which they can assess an entity's ability to generate cash and cash equivalents and where the money is spent based on the needs identified. This would aid users such as investors in formulating their investment decisions. For creditors or analysts, they could be able to assess the liquidity position of the entity which for the case of creditors could aid them in their lending decisions (IFRS – IAS 7, 2023).

Given the age of this Standard, the question may be raised whether it needs a profound review due to increased information needs and changing technology, or if only targeted improvements can lead to a better use.

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Chapter 1 - The Objectives of the Statement of Cash Flows - Corporates

This section deals with looking at the objectives of the statement of cash flows as a primary financial statement for corporates and how the different stakeholder groups that use the financial statements, view on what ought to be the objectives of the statement of cash flows.

The statement of cash flows does not have a particular purpose as a statement. Instead, the statement can be considered as a collection of useful data which, for example, can be used when adjusting or reconciling figures reported in the statement of financial position or statement of financial performance.

The objectives discussed in this chapter are based on the input collected during the roundtable sessions and relevant literature.

Criteria for selecting literature:

The literature selected has covered previous published academic papers, working papers that were available on the open access database journals, recent articles of topics from the financial industry that are related to the subject in question.

According to EY International Financial Reporting Group (2023), the purpose of the statement of cash flows is to provide information about:

(a) An entity's ability to generate cash for funding their operations;
(b) How it undertakes reinvestments and maintains its operating capacity;
(c) The ability to meet its debt obligations; and
(d) The distribution of dividends, and in general how an entity manages its cash.

The above are discussed in the following heading points based on the information collected from the roundtable sessions.

(a) The objective of the statement of cash flows it to provide liquidity information as part of financial analysis;
(b) The objective is to show movements of cash and cash equivalents and the interaction of cash balance with the net income;
(c) The objective is to describe an entity's business model and cycle, as well as provide information for discounted cash flows projections;

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To provide liquidity information

Academic Literature:

When an entity is preparing the statement of cash flows, the main purpose is to ensure that it discloses information about how it has been able to meet its financial obligations in the form of the cash inflows it generated, and the cash outflows it expended during a particular period. These cash flows are classified according to operating, investing and financing activities based on the financial theory which states that a business enterprise obtains cash to fund its investing activities and financing activities from either internal or external sources (Noor et al., 2012).

Engle (2012) argues that the concept of liquidity can be understood using a number of financial indicators, to which the statement of cash flows provides a platform whereby managers can track the liquidity position of their businesses. Cash flow budgets can then be prepared using the cash flow statements to provide management with an understanding of the proceeding year's cash inflow and outflow. This practice is important in all types of businesses where cash flow problems can be anticipated by management particularly for the case of small businesses.

Cash Flow statements have been used since the early XIX century by banks to assess the ability of an entity to service its debt obligations. Today they are at the heart of financial analysis in the markets (Chambost & Praquin, 2021).

Gebhardt and Mansch (2012) also account that the statement of cash flows provides information on the financial position of entities which could be a basis of assessing their liquidity position.

Views from the Roundtable Sessions and EFRAG Working Group Meetings:

A member (auditor) of the panel during the financial institutions roundtable pointed out, that the purpose of the statement of cash flows was to disclose information pertaining to whether an undertaking receives sufficient cash inflows to pay dividends and whether it can generate financial resources for reinvesting and making investment decisions. This view was confirmed by a preparer representative from the corporate community.

Another member (preparer) from the corporate's side roundtable session, highlighted that the statement of cash flows was prepared to explain an entity's performance in terms of how it can generate cash and be able to spend it.

The user community would always pick out elements to make their own assessment. For instance, for the equity analysts the capacity to pay back cash was the most important use. One may remark that for equity analysts it would then be the capacity to pay dividends.

An academic representative stressed that the statement of cash flows should enable a user to make discounted cash flow projections deriving from this objective.

A preparer representative stressed that the main purpose of the cash flows statement was to provide information on liquidity.

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To show movements of cash and cash equivalents & Interaction of cash balance with net income

Academic Literature:

The information presented by the statement of cash flows reflects an entity's true economic reality, since the cash inflows and outflows are shown objectively. This entails that the statement aims at reconciling the increase or decrease in an entity's cash and cash equivalents that have occurred during an accounting period (Van Greuning et al., 2011).

Views from the Roundtable Sessions and EFRAG Working Group Meetings:

A respondent (auditor) claimed that the statement of cash flows was prepared to show the reasons as to why an entity's cash balance did not change as much as its net profit level since, this enabled users to see whether companies were in a growth phase and soaking capital or whether growth was financing capital needs. It was therefore a tool for reconciliation. One preparer claimed that the statement of cash flows should help the user to assess the timing of cash conversion into capital. But for the time being they would not get the full picture between the profit and loss account and the statement of cash flows. It should help measure the performance of net cash excluding borrowing. A representative of the auditing industry claimed that the statement of cash flows should show how the income statement is generating cash. A preparer added that changes of cash should be made evident.

The IASB representative identified the users' needs to calculate net debt. Some users claimed it was not possible with the current statements.

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To explain an entity's business model and life cycle

Academic Literature:

The cash generated from operating activities is usually greater than the net income for the case of a financially sound company. If this is not the case, then the solvency position of the company has to be questioned. As the statement of cash flows provides information for the computation of free cash flows, a company having negative free flows may indicate that it is at the growth stage. This can be associated with the high capital expenditures and other investments. Mature companies on the other hand have positive free cash flows, whereas firms which are at the declining stage have lower levels of capital expenditures which in turn means that the firm has significantly positive free cash flows (Van Greuning et al., 2011).

Views from the Roundtable Session and EFRAG Working Group Meetings:

The input collected as far as the cash flow statement being an indicator of a company's model was echoed by one of the respondents (academic) who highlighted that the structure of the statement gave a good insight into a company's business model and life cycle, which was crucial to understanding future cash flows. One preparer confirmed that this would be the objective, but that IAS 7 did not give the full picture to users for making this assessment.

Chapter 2 – Uses of the Statement of Cash Flows - Corporates

This section is catered to highlight the practical uses of the statement of cash flows for corporates and users of corporates' financial statements. It will be wise to breakdown the users into many different types of stakeholders such as investors, equity analysts, credit analysts and any other external individual or organisation who may be interested with the information presented in the statement of cash flows. Academics are also distinguished from the other stakeholder group in this section as they also view the statement with a distinct perspective usually reflecting the teaching they conduct for subjects like financial analysis and academic research.

For this chapter, input was collected from the various roundtable sessions, EFRAG Working Groups (which also contained an Academic Panel meeting) and relevant academic literature.

The following list summarises the uses of the statement of cash flows:

a. The statement of cash flows can be used in assessing capital expenditures;
b. The statement of cash flows can be used to assess the impact of mergers & acquisitions;
c. The statement of cash flows can be used for assessing dividend possibilities;
d. The statement of cash flows can be used as a basis for predicting future free cash flows (element of valuation);
e. The statement of cash flows is used to analyse the liquidity position of an entity; and
f. The statement of cash flows can be used to assess management stewardship.

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Analysing Capital Expenditures (related to the objective of reinvestment decisions)

Academic Literature:

Capital Intensity Ratio:

As capital expenditure is recorded in the cash flow from investing activities under the IAS 7, corporates are able to analyse for instance the relationship between capital expenditure and revenues using capital intensity ratio which simply implies the amount of plant, property, equipment, inventory and other physical assets that are required to generate a unit of sales. This ratio could be useful for the case of a conglomerate, where products related to different industries are offered. This can help management in understanding the interaction of capital expenditure related to a particular product offering in relation to the revenues generated. The capital intensity ratio is calculating by dividing a company's annual capital expenditure by revenues (Elmasr, 2007).

Views from the Roundtable Sessions and EFRAG Working Group Meetings:

A user representative of the panel during the EFRAG FR TEG and EFRAG UP stressed out that the statement of cash flows is used when it comes to especially understanding capital expenditures incurred by the management. He was of the view that the statement of cash flows provides historical Capex numbers which enables to understand management's control of capital expenditures. In contrast, the income statement does not provide such information. A preparer representative pointed out that Capex could be compared with depreciations for assessing growth or correcting discounted cash flow projections.

Another respondent from the user panel highlighted the significance of the statement of cash flows in valuation and forecasting, as the working capital dynamics of business and capital expenditures relative to depreciation were key to understand a business's prospect for growth. A preparer also pointed out that it should help to assess whether the cash flows are being generated on a recurrent basis.

Assessing Dividend Possibilities (related to the objective of providing information pertaining to dividends)

Academic Literature:

Dividend Payout Ratio:

IAS 7.34 states that dividends paid may be classified as a component of the cash flows from operating activities. This assists users in determining the ability of an entity to pay dividends from the operating cash flows. (IAS 7 – Statement of Cash Flows)

Arnold et al. (2018) explain the dividend ratio as the ratio used in order to assess the possibilities of whether an entity can pay dividends. A higher ratio indicates that an entity would be able to increase the level of dividends paid. It is a tool of describing the degree of protection from equity investors. It is calculated as follows:

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$$Cash\ Flow\ Dividend\ Ratio = \frac{\text{Cash Flow from Operating Activities}}{\text{Common Dividends}}$$

Views from the Roundtable Sessions and EFRAG Working Group Meetings:

A user representative uses the statement of cash flows to distinguish cash and non-cash components of income and costs. One can deduct that this implicitly gives indications on the dividend distribution capacity. For one auditor, this is the main purpose of the statement.

Assessing the impact of Mergers & Acquisitions

Academic Literature:

Free Cash Flow Theory:

As the statement of cash flows provide companies information to calculate free cash flows, available academic literature suggests that the free cash flow theory is one the many theories that can be used to explain acquisitions to corporates in terms of its impact. The free cash flow theory can be used to predict the likelihood of mergers & acquisitions to either create value or not, and also shows the conflict of interest between shareholders and managers. As an entity generates free cash flows, management may want to use the free cash flows for further reinvestments whereas shareholders would seek for dividend payments. This theory highlights that managers of firms with high free cash flows have a tendency of undertaking mergers that are value-destroying because of their aggressive behaviour in order to undertake a merger or acquisition. On the other hand, users who observe entities with higher free cash flows would want to invest into the company taking into account the possibility of receiving dividend payments (Jensen, 1986).

The theory can be used by companies to explain why and how takeovers that are financed by cash and debt generate large benefits compared to those that are undertaken through the exchange of stocks because stock acquisitions are different from debt and cash as they are mostly associated with companies having a shortage of free cash flows but are seeking for growth opportunities. Thus, users would be able to assess the complication involved in a merger & acquisition. (Jensen, 1986).

Views from the Roundtable Sessions and EFRAG Working Group Meetings:

One academic representative stated that cash flow statement lectures only took place in Corporate Finance classes and not in accounting. This implicitly shows the importance for M&A transactions.

A user representative uses the statement of cash flows to distinguish cash flows which are related to non-controlling interests.

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Basis of predicting free cash flows (Valuation)

Academic Literature:

Free cash flows (Valuation):

(Gebhardt & Mansch, 2012) see the statement of cash flows not only as a tool for liquidity assessment but also for entities' valuation and the steering of value-based management practices.

Free cash flow is the cash that has remained in the company after paying to support its operations and capital expenditure. It is an indicator of how much cash a company is generating after incurring relevant costs of running the enterprise. It also provides an insight of the company's business model and financial position (Morningstar, 2023).

In France, IAS 7 Cash Flow statements have replaced the French table of financing to a great part, as Anglo-Saxon reporting is more oriented towards investors (Ding et al., 2020).

Views from the Roundtable Sessions and EFRAG Working Group Meetings:

A user of the panel member mentioned that investors use information from the statement of cash flows to also forecast future cash flows. For the case that positive free cash flows have been forecasted, this would indicate that the company would be able to return money to shareholders in the form of dividends.

Another user stressed out that the statement of cash flows is used by him to identify and understand the factors affecting enterprise value.

Assessing the liquidity condition

Academic Literature:

Reliability of cash flow information in liquidity analysis:

Information from the statement of cash flows facilitates management and users in determining the actual liquidity position of a business enterprise as the information is much more relevant than that obtained from the balance sheet and income statement. The data captured in the balance sheet is for a single point in time whereas the income statement contains many arbitrary non-cash allocations (e.g., depreciation and amortization). Hence, the statement of cash flows shows the changes in the other statements and discloses information that shareholders are really interested in cash available for operations and investments (Kajananthan & Velnampy, 2014).

According to Billah et al. (2015), their study focused on analysing the liquidity position of selected public listed companies in Malaysia operating in the consumer products, industrial products and Trading/Services sector using both traditional liquidity ratios and cash flow statement ratios. The study revealed that the cash flow statement ratios should be used hand in hand with the traditional liquidity ratios since the cash flow ratios provide additional information and better insights into the liquidity position of a particular company.

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The following table illustrates the traditional liquidity ratios and cash flow statement ratios used in the study:

Figure 1: Traditional Ratios and Cash Flows Ratios

Traditional Ratios		**Cash Flow Ratios**		
Ratios	Formula	Ratios	Formula	Measure
Current Ratio	CA/CL	CFO to CL	CFO/CL	Liquidity
Quick Ratio	(CA-Inventories)/CL	Critical Needs Cash Coverage	(CFO + Interest Paid) / (Total Current Liabilities + Interest	Liquidity
TA to TL Ratio	TA/TL	CFO to TL	CFO/TL	Solvency
Interest Coverage Ratio	EBIT/Interest Expense	Cash Flow Interest Coverage	(CFO + Interest paid + Taxes paid)/Interest paid	Solvency

Source: Billah et al., 2015

Key: CA=Current assets, CL= Current liabilities, TA=Total assets, TL= Total liabilities, EBIT= Earnings before interest and income tax, CFO= Cash flow from operations.

Views from the Roundtable Sessions and EFRAG Working Group Meetings:

During the EFRAG Working Group Meetings, user representatives echoed that the statement of cash flows was used in assessing the liquidity position of an entity. This was much relevant to creditors whose focus was to see whether an entity generated enough cash inflows in order to meet its short-term and debt obligations.

Management Stewardship

Views from the Roundtable Sessions and EFRAG Working Group Meetings:

Understanding of Management Policies:

A respondent (user) in one of the EFRAG Working Group Meetings remarked that the statement of cash flows was an important financial statement as it provided a summarised version of information pertaining to management's stewardship. One can learn a lot from the information provided by the statement of cash flows for instance, by assessing the historical Capex numbers a user can understand the extent to which capital expenditures have contributed to the profit in the income statement. Furthermore, the statement of cash flows provides information as a basis of understanding management policies and plans and whether management has control of the finances. It answers the question, whether the entity has the money it is spending.

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Chapter 3 - The objectives or uses of the Statement of Cash Flows for Financial Institutions (Banks and Insurance Companies)

Banks and insurance companies have a different view when it comes to the statement of cash flows. This chapter looks at the purpose of the statement of cash flows in the eyes of banks and insurance companies and tries to highlight if at all the statement of cash flows is of relevance to them.

According to the roundtable session, which was conducted for financial institutions, a respondent (insurance auditor) highlighted that the primary objective of statement of cash flows was to provide information about an entity's ability to pay dividends from the cash inflows it generates as well show case an entity's ability to generate the financial resources which would be used for reinvestments.

For insurance companies, cash flow streams are inverted. They would first receive money before they spend it. Therefore, the meaningfulness of the statement of cash flows for the industry was limited. Users contradicted this argument in another roundtable arguing that the other industries such as the travel industry experienced similar cash flow patterns. They also claim that some parts of the statements are still useful, such as changes in different types of debt. With this said, the respondent (insurance auditor) claimed that the statement of cash flows in the context of insurance industry does not provide sufficient information for liquidity risk reporting as it does not provide predictive information for financial institutions.

The same type of concern was echoed a bit louder from the respondents of the banking sector where the majority of the respondents who actively engaged in the conversation highlighted that the banking sector's focus was to report on regulatory capital requirement and liquidity risks disclosures as these were deemed most important compared to the statement of cash flows. Users of the statement of cash flows such as those who would use it for internal purposes, analysts and regulators also reiterated that the statement was not useful. They also added that the current statement of cash flows under IAS 7 could be enhanced to accommodate the banking sector's business model since at the moment elements such as interest rate risk, liquidity and duration mismatch were not reflected on the statement of cash flows.

It is also noted that the feedback from EFRAG's Discussion Paper on cash flow statements from 2015 and July's 2023 FIWG was that the use of the statement of cash flows are limited for financial institutions. This view was then confirmed in the roundtable discussions. One academic representative however stressed that it depended on the business model of the bank. It could also give an indication on the amount lent and recovered.

Hence, this section lays down the objectives and uses of the statement of cash flows as discussed in the following sessions:

a) Financial Institutions roundtable session;
b) EFRAG 2015 Discussion paper on the issues of statement of cash flows for financial institutions; and
c) EFRAG Working Groups.

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Before providing the relevant views of the aforementioned sources, it would be wise to provide the general information of the input from earlier EFRAG Working Group meetings about the objectives and uses of the statement of cash flows for banks and insurance companies.

Objectives of the statement of cash flows for the banking industry

a) The statement of cash flows is simply considered as complementary to the other two primary financial statements (statements of financial performance and the statement of financial position). There is no explicit objective of the statement apart from having information that could be used for analysis together with the information provided in the other primary financial statements;
b) The objective viewed by the banking sector is that the statement of cash flows aims to provide information on how cash is generated. However, since the business model of banks is different to corporates, the banking sector is of the view that the other primary financial statements provide this information.

Uses of the statement of cash flows for the banking industry

It was viewed that for the banking industry, most of the information on the statement of cash flows is used, together with other information in the following aspects:

a) The statement could be used to forecast future cash flows (however some respondents claimed that most of the relevant information is included in the statement of financial performance);
b) The statement could be used in assessing core liquidity ratios and how they can be expected to evolve over time (however, respondents also claimed that most of the relevant information is included in the statement of financial performance);
c) The statement is used for comparing cash and non-cash components of income and costs;
d) The statement is used for analysing Capex; and
e) The statement is used for debt-service analysis.

Objectives/uses of the statement of cash flows for the insurance industry

The following were the views relating to the objectives of the statement of cash flows for the insurance industry:

a) The statement of cash flows could contain some useful information which could be used to explain the changes in different types of debt; and
b) Another view is that the statement of cash flows is not useful for the insurance industry because of its business model (cash inflows preceding the cash outflows).

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Views from the financial institutions’ roundtable session

Both preparers and users of the statement of cash flows for banks and insurance companies highlighted that they had been questioning the relevance of the statement of cash flows for their respective sectors.

However, one of the preparers representing a bank remarked that his bank would continue preparing the statement, and highlighted that it was not cumbersome or labour intensive to prepare it.

All in all, the conclusion derived from this roundtable was a proposal on “**A potential discussion about alternative reporting requirements: Liquidity risk reporting requirements through various statutory reporting requirements.”**

This is discussed in chapter 4 (alternative reporting requirements).

EFRAG 2015 Discussion Paper – The Statement of Cash Flows: Issues for Financial Institutions

As per the (EFRAG DP 2015), financial institutions reacted to the proposals which were laid in the IASB Discussion Paper: *Preliminary Views on Financial Statement Presentations* that was published in October 2008. The proposals for the statement of cash flows were to:

(a) Maintain the requirement to disaggregate cash flows into operating, investing and financing;
(b) Present cash flows in a manner consistent with the classification of the related asset, liability or equity in the statement of financial position and the related item of income expense in the statement of comprehensive income (cohesiveness principle);
(c) Maintain the requirement to present a reconciliation between the profit or loss from operating activities and cash flow from operating activities;
(d) Prepare and present cash flows using the direct method; and
(e) Present cash flows on a gross basis with some exceptions like those currently in IAS 7.

The following are comments extracted from the letters of banks and insurers addressing their objection to the proposals contained in the EFRAG 2015 Discussion Paper:

Banks do not use the statement of cash flows as a managing tool:

The management of a bank does not view the statement as a tool to assess the bank’s liquidity risk and perform analysis to determine the bank’s ability to generate cash and create value for shareholders (EFRAG DP, 2015).

The statement of cash flows cannot be used to assess liquidity risk:

For banks, the statement of cash flows does not provide a basis of assessing their economic future as future cash flows cannot be forecasted simply based on accounting information. They are derived from assets and liabilities on the balance sheet at specific date as well as future production of loans and the

bank's funding. The statement of cash flows provides historical information and gives little information about a bank's liquidity exposure (EFRAG DP, 2015).

The statement of cash flows does not provide information on the value-creating process:

The business of banks is based on their ability to manage the transformation of short-term deposits into long-term credits. The information contained in the statement of cash flows relates to past transactions that provide or use cash. Therefore, the statement provides a restrictive observation of the activities that create value for banks since the share of transactions settled by cash and via customer's current account is "arbitrary between periods" (EFRAG DP, 2015).

The classification into operating, investing and financing being irrelevant:

The classification into either operating, investing and financing activities is irrelevant for financial institutions because of the nature of their operations, in which assets and liabilities are "fungible" as well as the interconnectedness of balance sheet items (EFRAG DP, 2015).

The direct method does not provide relevant information for banks:

The direct method for banks is insignificant to bank's management and is not of use to users because it does not provide information relating to the change in net assets of a bank, its financial structure and its ability to influence the amounts and timings of cash flows. The reason being that cash transactions for a bank happen daily and they are not under the control of banks. Customers control these transactions as the decide on the amounts and timings of payments and receipts (EFRAG, DP 2015).

EFRAG Working Groups: IAWG and FIWG November 2014 Discussions

Members of the IAWG expressed their views that the statement of cash flows is not very useful because (EFRAG DP, 2015):

(a) The classification of cash flows into operating, financing and investing is not useful;
(b) Cash flows and valuation are not necessarily related since there are many approaches in valuation apart from the discounted cash flows methodology; and
(c) Analysts usually demand "recuring cash flows" generated by entities to which this information cannot be derived from the statement of cash flows.

The FIWG members also expressed their views that the statement of cash flows has limited usefulness for banks because (EFRAG DP, 2015):

(a) It is not important for a bank to show reconciliation between a measure of performance and cash flows since for banks the performance is not necessarily the main drivers for the change in cash; and
(b) Cash and cash equivalents is not an indicator of liquidity.

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View from users – Feedback on the Financial Statement Project

Analysts remarked that their focus was more on the changes related to specific items on the balance sheet rather than the sources of use of the cash on the balance sheet. Moreover, they also noted that the classification of cash flows into operating, investing and financing was not useful for financial institutions. Some users also pointed out that they did not use the statement of cash flows prepared under the indirect method which was mostly preferred by banks and insurers (EFRAG DP, 2015).

In addition, users also remarked that they would be interested to extract information which was not presented in the statement. These related to:

(a) Cash interest paid and received (the would be presented under the direct method as per IAS 7); and
(b) Cash from loan originations and cash collection from repayment of principal (this can be presented on a net basis as per IAS 7).

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Chapter 4- Alternative Reporting Requirements

This section deals with the alternative reporting requirements for insurance companies, banks and corporates.

Banks and insurance companies are required to prepare the statement of cash flows. However, these sectors have different respective opinions on the usefulness of the statement of cash flows because of the nature of their operations. For the case of banks, the following disclosures are important:

a. Liquidity Risk Management
b. Interest Rate Risk Management
c. Asset Liability Management

For corporates, users of their financial statements such as analysts and investors are of the view that preparing a net debt reconciliation which shows an entity's debt levels for a particular period due to its cash flows and other non-cash movements would provide information about how an entity has financed itself (PWC, 2011). This was confirmed by a user representative who analysed entities' debt levels using the net debt reconciliation approach. Preparers and users also remarked about the use of the statement of changes in working capital and statement of changes in cash.

According to a recent article by KPMG (KPMG Corporate Treasury, 2023), the Solvency II directive intends to ensure that all insurance companies have sufficient capital to meet their obligations. It consists of the following three pillars:

I. Quantitative requirements for risk management
II. Qualitative risk management requirements
III. Disclosure of information to create transparency

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Insurance companies

The focus of insurance companies on the other hand is on Liquidity Risk Management. The Solvency II which came into force on 01.01.2016 as part of the Solvency II Directive (Directive 2009/138/EC) introduced enhanced solvency requirements for insurers based on holistic approach of risk assessment and imposed new assessment rules for assets and liabilities. The aim of this directive was to reduce insurance companies' insolvency risk (BaFin, 2016).

Views from the Roundtable Session and EFRAG Working Group Meetings:

During the financial institution roundtable, remarks were made (by an insurance auditor) for the reporting of insurance companies that, disclosures related to liquidity were of importance to the sector than a statement of cash flows.

Furthermore, suggestions were also made with respect to the (assessment of future liquidity for insurers) where information about product description and how customers are penalized in the event of withdrawing money. This could be considered for the assessment of an insurer's future liquidity.

A user representative stressed the importance of getting comparable information on the term structure for the assets and liabilities in order to get an overview of the asset liability management. Solvency II indicators could be used as a guideline.

As per the letter written by the Dutch Accounting Standards Board (DASB) to the EFRAG Technical Group, the board remarked that financial institutions are normally operated with managing cash and all types of cash related products. This makes it as a primary business activity and therefore the current format of the statement of cash flows does not fully reflect this. They added, the financial risk management and liability management are important to financial institution's day-to-day business operations and affects the financial position. Hence, risk management related information about the cash inflows and outflows of financial instruments are a key element in understanding financial institution's financial position (DASB, 2016).

Banks

Academic Literature:

Banks are also governed by the directives issued by the Basel Committee in Banking Supervision in light of the 2007-2009 financial crisis. The objective of Basel III is to ensure that banks handle shocks from financial distress as well as improving their transparency and disclosures. Basel III is based on the foundations already set by Basel I and Basel III (Delphix, 2023).

The principles of Basel III in summary are as follows:

a. Increase in minimum Basel II capital requirements for banks from 2% in Basel II to 4.5% of common equity (percentage of a bank's risk weighted assets.
b. Extra 2.5% buffer capital requirement

Scenario stress testing typically include programs undertaken by a bank to assess its financial stability due to sever economic downturns to enhance the level of information transparency and facilitate proper risk assessment to improve investor confidence (Abad et al., 2023).

As (Halaj, 2020) points out, banks are faced with two major vulnerabilities which are funding liquidity risk and interconnectedness (structural). Funding liquidity risk is the risk that a bank is not able to pay the deposits that are demanded by its customers. Interconnectedness refers to the connectedness of banks in two ways namely; direct, and indirect. Direct connectedness results from bilateral transactions between two banks (inter-bank lending) which would imply that, were one of the banks to become insolvent the other bank would also be affected. Indirect connectedness could reflect a situation where a distressed bank may decide to sell a large amount of assets in a short time which could lead to decline in asset prices and mark-to-market losses (Bank of England, 2015).

Views from the Roundtable Sessions and EFRAG Working Group Meetings:

A panel (other-user) representing the banking sector during the financial institution roundtable remarked that there could be a possibility of re-adjusting IAS 7 – *Statement of Cash Flows* to incorporate these banking related disclosures by looking at the best possible practises banks could implement in ensuring that they produce a more detailed principle-based disclosure requirement.

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Another panel (academic) at the financial institutions roundtable highlighted whether there could be a possibility of developing a new reporting standard or system which would reflect liquidity risk reporting by conducting scenario stress testing for banks due to interest rate movements. This standard could also accommodate banks' dynamic risk management disclosures.

Another opinion contributed by users of bank's financial statements remarked that as an alternative reporting approach, some analysts prepared a statement showing the flow of regulatory capital instead of a statement of cash flows. These statements might be useful to banks as they provide information related to equity - analysis of whether equity would be growing sufficiently to finance growth in the loan book or whether additional capital had to be issued. Furthermore, a remark was also made by a user that since there was no real objective of the statement of cash flows for banks, it would be more useful to provide note disclosures than preparing the statement.

The user representative also shared an opinion pertaining to the alternative reporting requirement in the context of a bank's liquidity risk disclosure. He agreed that liquidity risk disclosures were of more help to users and investors when analysing banks than statement of cash flows. Considering this, banks could have standardized tables showing different scenarios and situations that banks could avoid. This was substantiated with the recent events that occurred in the U.S. financial markets and the 2008 financial crisis where interest rate movements impacted the liquidity draw-out of banks which resulted into depositors withdrawing their deposits from banks.

Therefore, these standardized tables can be a tool in assessing the durations of assets and liabilities.

With respect to assessing the durations of assets and liabilities, a user illustrated an example of Silicon Valley Bank's failure and attributed it simply to the bank not foreseeing the effects of locking its depositor's money into relatively low interest rate securities. The bank's core business was to lend money to tech and biopharma start-up companies, and it funded these loans by accepting large deposits from technology companies which were cash rich. For the bank to be able to generate a good return on these deposits it decided to invest the deposit money in secure long-term Treasury bonds. These are securities that are issued by the Federal Government and are very low risk and pay a slightly higher interest rate than comparable short-term investments. Everything was running well as anticipated by the banks until recently when the Federal Reserve bank began raising interest rates. These higher interest rates pressured the bank into providing favourable rates of return to its depositors. However, the bank was unable to do this because it had already locked itself into the long-term low interest Treasury Bond. As a result, depositors started withdrawing funds as they looked for higher interest rates. This forced the bank to sell some of its Treasury bonds at a loss because bonds fall in value when interest rates rise. As depositors kept on withdrawing their money, the bank started facing liquidity problems and thus, it filed with the Securities Exchange Commission (SEC) to raise funds to pay its depositors. Depositors saw this action as evidence that the bank was insolvent. Therefore, they went on withdrawing their money which caused a "run on the bank" (Warr, 2013).

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Input from the 2015 Discussion Paper – Issues for Financial Institutions

The Discussion Paper discussed about the issues of the statement of cash flows for financial institutions by presenting alternative reporting requirements to which firstly, the main step was to identify an approach that would be used in defining financial institutions which had concerns with the current IAS 7 – statement of cash flows. Hence, the entities defined were those that engage in deposit-taking and/ or in underwriting life-insurance (EFRAG DP, 2015).

As for the banks, disclosures pertaining to liquidity disclosures such as Liquidity Coverage Ratio (LCR) and Net Stabel Funding Ratio (NSFR) have been developed by the Basel committee. However, it was also noted that there is no single metric that can extensively quantify liquidity risk. So, these disclosures could be used as a starting point to develop alternative reporting requirements in IFRS (EFRAG DP, 2015).

The Discussion Paper also pointed out that the current definition of cash and cash equivalents by IAS 7 is not in line with the way commercial banks manage their liquidity because commercial banks focus on highly liquid assets for which the current IAS 7 for short term maturity does not address this issue. An example would be long term government securities available as collateral for refinancing transactions with a central bank which are considered as liquidity reserves by most banks (EFRAG DP, 2015).

Corporates

As alternative reporting requirement for corporates, the following approaches were identified bypreparers, users and academics during the various roundtable sessions and meetings:

a) Net debt reconciliation
b) Statement of changes in working capital
c) Statement of changes in cash and not cash equivalent.

Net debt reconciliation:

According to the first issue of the PWC's `Investor view´ series, members of the Corporate Reporting Users' Forum in 2009 at the `Meet the Experts` conference in London, investors proposed the Net debt reconciliation at it could provide users with appropriate information of ascertaining a corporate's liquidity and solvency position (PWC UK, 2013)

A net debt reconciliation shows the movement of a company's debt level over a particular period due to cash flows and other non-cash movements. It is a reconciliation to the items in the statement of cash flows and is still not required under the IFRS.

The advantages it brings to investors is to enable them to see how an entity's business financing has changed throughout the year. It also provides information about:

a. Debt required or disposed of in business combinations
b. Foreign exchange movements arising on debt
c. Information that is not always obvious elsewhere in the financial statements

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Views from the Roundtable Sessions and EFRAG Working Group Meetings:

During the roundtable sessions and EFRAG Working Group Meetings, the statement of changes in debt was proposed by the panel members as an alternative reporting requirement. It was argued that this statement could bring advantages such as:

a. The statement would be more useful for determining enterprise value
b. Issues related to non-cash transactions would be solved
c. It would capture working capital and debt-servicing dynamics

Figure 2: Example of a Net debt reconciliation GlaxoSmithKline Plc 2022

	2022 £m	2021 £m	2020 £m
Net debt, at the beginning of year, as adjusted	(19,838)	(20,780)	(25,215)
Increase in cash and bank overdrafts	(7,597)	(2,504)	(1,579)
Increase/ (decrease) in liquid investments	(1)	(18)	1
Increase in long-term loans	(1,025)	-	(3,298)
Repayment of short-term Notes	5,074	2,304	3,738
Repayment of/ (increase in) other short-term loans	(1,021)	(301)	3,594
Repayment of medium-term notes (MTN)s	1,594	-	-
Repayment of lease liabilities	202	181	182
Debt of subsidiary undertakings acquired	(24)	-	-
Exchange adjustments	(1,531)	314	(128)
Other non-cash movements	(207)	(134)	(102)
Decrease/ (increase) in net debt from continuing operations	(4,536)	(158)	2,408
Decrease/ (increase) in net debt from discontinued operations	7,177	1,100	2,027
Total net debt at end of year	(17,197)	(19,838)	(20,780)

Source: GSK Annual Report 2002

Statement of changes in working capital:

Working capital is the money that is available for business enterprises to meet their current and short-term obligations (Bank of America, 2023).

A statement of changes in working capital is prepared to record the changes in current assets and current liabilities that have occurred in an accounting period. The purpose of preparing a statement of changes in working capital is to analyse the increase of decrease of each individual item of the current assets and current liabilities which would then explain the net increase or decrease in working capital (Tramplin, 2023).

Views from the Roundtable Sessions and EFRAG Working Group Meetings:

During the catch-up roundtable organized for the corporates, a preparer highlighted that their company also prepared the statement of changes in working capital which was majorly comprised of changes in receivables, changes in inventory and changes in liabilities. These were also considered as operating activities however, she admitted that their company was still facing a difficulty in defining working capital as there was no standard definition or acceptable definition of working capital. Therefore, they used their own policies and understanding in defining working capital. Furthermore, it was also noted that users and investors of this company were interested to know about the factors that would affect the change in working capital for example; the impact of customer prepayments and the actual liabilities the company had to pay for.

Statement of changes in changes in cash

Views from the Roundtable Session and EFRAG Working Group Meetings:

At the academic panel meeting, a user pointed out there was a study conducted which highlighted that, creditors used the statement of cash flows differently. They did not use the statement as it is required to be prepared by IAS 7, but they used different cash flow statements which only considered changes in cash and not changes in cash equivalents. This facilitated the creditors in assessing the likelihood of entities to repay back their debts.

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Chapter 5 - Conclusion

Therefore, this report has laid down the various objectives and uses of the statement of cash flows as prepared under IAS 7.

It must be clearly noted that the current statement of cash flows under IAS 7 is of less significance to the financial institutions i.e., banks and insurance companies because of the nature of their business models and the type of reporting requirement and disclosures associated with them.

For corporates, the statement of cash flows is still relevant and important. However, adjustments must be considered by the IASB so to revise the standard so as it can be able to accommodate all types of objectives and their use due to the ever-changing economic environment. Users miss elements to predict future cash flows and make the reconciliation with the statement of profit or loss. In addition, net debt calculations are difficult to fulfil.

The issues of pertaining to the preparation of the statement of cash flows under IAS 7 is dealt in depth in the second part of this proactive research.

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