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DISCUSSION PAPER

THE STATEMENT OF CASH FLOWS—OBJECTIVES, USAGES AND ISSUES

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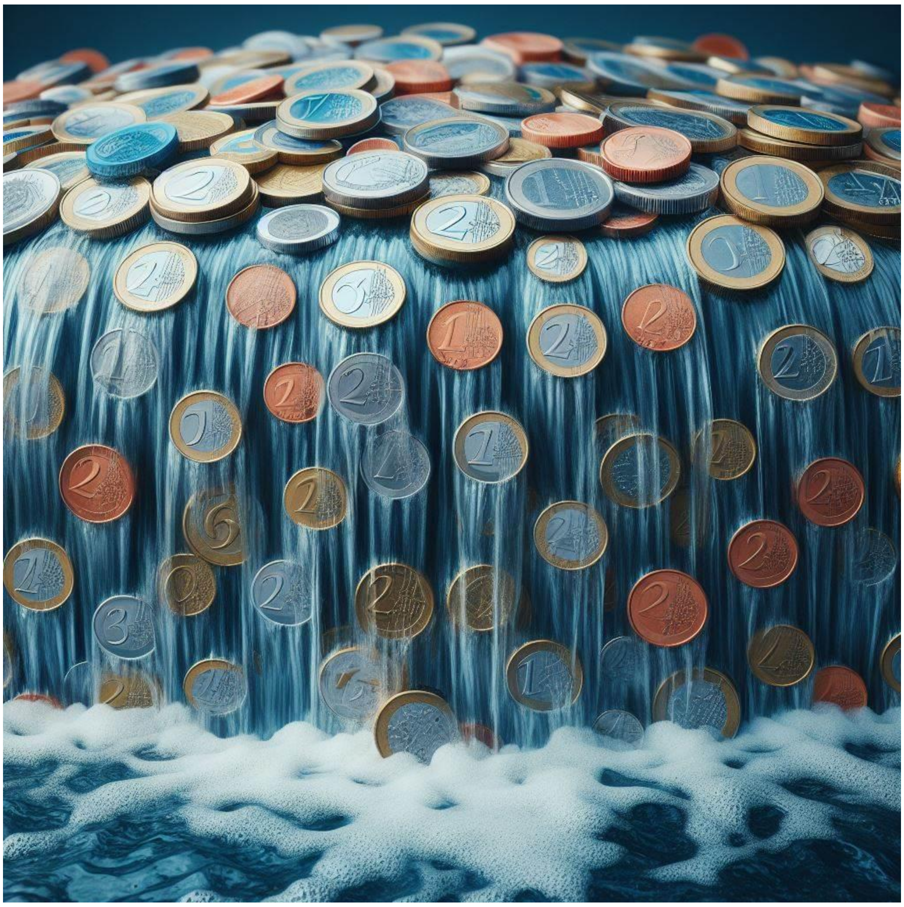

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EFRAG welcomes comments on its proposals via the 'Questions to Constituents' at the end of each section. Such comments should be submitted through the EFRAG website by clicking [here-insert hyperlink]

Comments should arrive no later than [Comment Deadline Date]. EFRAG will place all comments received on the public record unless confidentiality is requested.

EFRAG Research Activities in Europe

This paper is part of EFRAG's research work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. Four strategic aims underpin proactive work:

- engaging with European constituents to understand their issues and how financial reporting affects them;
- influencing the development of International Financial Reporting Standards ('IFRS Standards');
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research work and current projects is available on the EFRAG website.

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Executive Summary

Purpose of this Discussion Paper

ES1 The main purpose of this Discussion Paper ('DP') is to list the issues that currently exist for statements of cash flows prepared in accordance with IAS 7 *Statement of Cash Flows*. However, as perceived issues with the statement of cash flows would depend on how the statement of cash flows is used, this DP first considers the objectives and usages of the statement of cash flows. Acknowledgement of the different perceived objectives of the statement of cash flows is also necessary when addressing the identified issues as providing more relevant information for one objective could impede the relevance of the information provided in the statement of cash flows for another objective.

Structure of the DP

ES2 Following the purpose of this DP as stated above, the DP first discusses the objectives and usages of the statement of cash flows. It then continues with discussing the issues for non-financial entities and an alternative to the statement of cash flows for non-financial entities. As there are particular issues with the statement of cash flows for financial institutions, these are considered in a separate chapter in the DP together with alternative reporting that might be more relevant to provide for these entities instead of a statement of cash flows. Finally, the DP discusses the benefits and problems of limiting amendments to IAS 7 to targeted improvements instead of performing a comprehensive review.

Objectives of the statement of cash flows

ES3 Based on the descriptions in the IASB's Conceptual Framework for Financial Reporting (the 'Conceptual Framework') and IAS 7 of the benefits of information included in the statement of cash flows, the DP deduces the following objectives. These objectives are related to the main objective of financial reporting: providing information to help the primary users of financial reporting performing their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity:

- Evaluating the changes in net assets. This includes the objective of understating the entity's business, and assessing accruals, which includes both assessing the closeness to cash of reported performance and assessing the current performance of the entity.
- Assessing the entity's financial structure, including liquidity and solvency.
- Assessing the entity's agility, which is how easily an entity can adapt to changing circumstances and opportunities. A high level of cash may make it easier for an entity to grab opportunities that may arise. On the other hand, the return on cash is often much lower than the return could get from having the cash invested or the return the shareholders could get from the invested money if they had been distributed as dividends.
- Assessing the entity's ability to generate cash and cash equivalents. Academic literature point in different directions on whether earnings or cash flow figures are best at predicting future cash flows. However, most, but not all, literature suggests that at least cash flow information has an added value.
- Comparing entities using different accounting treatments for the same transactions. It is not stated, neither in the Conceptual Framework, nor in IAS 7, but this could include assessing earnings management.

ES4 The statement of cash flows is also useful for the second main objective of financial reporting: to help the primary users of financial statements on their assessment of management's stewardship of the entity's economic resources. The statement of cash flows can both provide information for the assessment of the management's general performance and the management's cash management.

ES5 For all of the deduced objectives, the information included in the statement of cash flows should not be considered in isolation but together with other information included in the financial statements.

Usages of the statement of cash flows

ES6 Input collected by EFRAG and academic literature indicate that the statement of cash flows is used for the deduced objectives listed in the DP. However, the extent to which the statement of cash flows is used varies significantly from one user to another.

ES7 For example, when looking at whether the statement of cash flows is used to assess accruals, input collected by EFRAG suggests that for some, increases in accruals is a red flag. However, academic research does indicate that investors over-estimate the persistence of the accrual component of earnings and under-estimate the persistence of the cash flow component of earnings. Accordingly, a trading strategy with a long position in low accrual firms and a short position in high accrual firms generates significant abnormal returns in the subsequent years.

ES8 For the assessment of the ability of an entity to generate cash and cash equivalents, some users base their assessments on cash flow estimates, but despite academic literature and prepares claiming that the cash flows presented by entities are better than the figures that users can calculate themselves from the statement of profit or loss and the statement of financial position, some users do calculate cash flows using their own models. However, some would, for example, make use of the capital expenditure figures from the statement of cash flows when calculating, for example, free cash flows.

Issues with statement of cash flows for non-financial entities

ES9 The DP lists perceived issues with the statement of cash flows for non-financial entities. EFRAG has thus not limited the issues listed in the DP to those it assesses to be issues. The perceived issues relate to:

- included/excluded transactions
- classification
- presentation of cash flows from operating activities
- insufficient disclosures
- need for more disaggregated information
- definitions
- cohesiveness with other financial statements

Included/excluded transactions

ES10 The issues on included/excluded transactions relate to:

- Uncertainties about what is included in 'cash and cash equivalents'. For example, there are questions on whether cash in transit fall within the definition; what the meaning is of 'short-term maturity'; how much emphasis should be placed on the reference to 'three months'; and whether central bank digital currencies would be cash and cash equivalents. There is also concern that implicitly an investment per default is not a cash equivalent. This could mean that similar types of investments could be chosen to be cash equivalents by one entity, if that entity would collect the necessary evidence to support this assessment, while another entity would not want to spend the efforts in collecting the necessary evidence and hence just consider the investment not to be a cash equivalent.

These issues could affect the comparability of the statement of cash flows between entities and also affect the understandability of what is actually included and therefore also to some extent affect the perceived faithful representation.

- The requirements on what is 'cash and cash equivalents' do not result in the most relevant information. For example, the definition of what is cash equivalents is too restrictive for the assessment of solvency by credit agencies, which may have a broader focus and look at investments that could be converted into cash a six-months period. On the other hand, for the liquidity analysis, it is not useful to have items that cannot immediately be converted into cash.
- Uncertainty on how to deal with agent/principle like transactions. There are differing views on whether the cash flows of a party acting in a transaction as an agent of the entity should be included in the statement of cash flows. For example, if an entity is requesting a bank to acquire an asset on its behalf for which the bank would also provide a financing solution. Similarly, there is divergence in practice on whether to include VAT cash flows in the statement of cash flows.
- Excluding certain non-cash transactions does not result in comparable information. For example, some consider that the purchase of an asset by the transfer of own shares or crypto currencies is economically the same as first selling own shares or crypto currencies and then pay for the asset in cash. However, while the first transaction would not be reflected in the statement of cash flows (the acquisition would not appear from the capital expenditures), the latter transaction would. This is considered not to result in comparable information. Similarly, if an asset is purchased by assuming a directly related liability this acquisition may not appear from the statement of cash flows whereas it would appear if obtaining the financing and acquiring the asset would be done separately.
- Excluding certain non-cash transactions does not result in the most relevant information for all of the deduced objectives of the statement of cash flows. As stated above, excluding certain non-cash transactions from the statement of cash flows may impair comparability between entities, it is also considered to impair the relevance of the information included in the statement of cash flows for the deduced objectives. On the other hand, including cash flows in the statement of cash flows that have not taken place could be argued not to be a faithful representation.

Classification

ES11 The amendments to IAS 7 following the issuance of IFRS 18 *Presentation and Disclosure in Financial Statements* removed some of the options on how to classify interests and dividends, but there is divergence in practice in relation to the classification of many other types of transactions, including (but not limited to): payments to unfunded defined benefit pension schemes; cash received from factoring of trade receivables, cash received from government grants; cash payments related to the purchase of an asset on deferred payment terms; cash received in a sale and lease back arrangement where the transaction qualifies as a sale; payments of variable consideration; and how to classify cash received and cash payments related to derivatives that are 'collateralised-to-market'.

ES12 These differences in classification result in the statements of cash flows between entities not being comparable.

ES13 The requirements on classification are also considered not to always result in the most relevant information. For example, if an entity has a supplier finance arrangement which extends the purchaser's (the entity's) payment terms, it could be that all payments related to goods and services acquired by the entity would be presented as financing cash flows. This may not result in the most relevant information, for example when assessing the entity's ability to generate cash from its operations. A solution could be to present the cash flows from a supplier finance arrangement similar to if the entity would have borrowed money and paid its suppliers with this money. However, it can be questioned whether such a presentation would provide a faithful representation of the actual cash flows.

ES14 In relation to the classification requirements some do also not think that it results in the most relevant information to:

- Only classify expenditures that are capitalised as cash flows from investing activities. It is considered that this result in operating cash flows being understated. Also, this requirement reduces the relevance of the statement of cash flows for comparing entities applying different accounting policies (which is one of the deduced objectives of the statement of cash flows).
- Classify inflows can be classified as resulting from operating activities, while the related outflows are presented under another activity. As mentioned previously, this can happen for supplier finance arrangements, but also in relation to government grant.
- Not distinguishing between finance and operating leases as in the previous IAS 16 *Leases* standard.
- Classifying by default payment of taxes under operating activities and not having a separate category for taxes which would align better with IFRS 18.

Presentation of cash flows from operating activities

ES15 Allowing both the direct and indirect presentation of cash flows from operating activities affects comparability and also the type of information on accruals that will be available to users. Although academic research generally seems to favour the direct presentation, the European users EFRAG has consulted prefer the indirect presentation.

Insufficient disclosures

ES16 Compared with many other IFRS Accounting Standards, IAS 7 does not include many disclosure requirements, and some express a wish for additional information on:

- preparation and classification choices made by the entities;
- intercompany cash flows;
- restrictions on cash and where cash is placed in a group. There are currently some requirements on disclosures on restrictions of cash, but users do not consider they get sufficient information about this;
- liquidity and ability to service debt – including information helping assessing liquidity mismatches;
- non-cash income;
- non-recurring cash flows;
- impacts of business combinations;

ES17 Also, there are some indications that some struggle to understand the connections between the statement of profit or loss, the statement of financial position and the statement of cash flows, for these some reconciliations could be useful.

Need for more disaggregated information

ES18 Some consider that IAS 7 allows for too much flexibility on how to aggregate information in the statement of cash flows. This has resulted in the level of disaggregation being insufficient for the statement of cash flows from some entities. However, the principles of aggregation and disaggregation of IFRS 18 should help entities in determining the line items to present in the statement of cash flows, and the material information to be disclosed in the notes.

ES19 Some have expressed a wish to have capital expenditures related to maintenance presented separately from capital expenditures related to growth. Other have, however, questioned whether such information can be provided in a manner that would be useful.

ES20 On users' wish list is also a separation of dividends to controlling and non-controlling interests.

Definitions

ES21 To have more consistent disclosures and presentations, it has been suggested to define:

- working capital;
- net debt (this is particularly needed if the statement of cash flows, as discussed below, would be replaced by an explanation of changes in net debt);
- free cash flows.

ES22 Also, if preparers should be able to distinguish between capital expenditures used for growth and maintenance (see paragraph ES19 above) these different types of capital expenditures would need to be defined.

Cohesiveness with other financial statements

ES23 Differences between the categorisation used in the three primary statements can cause confusion. Particularly after IFRS 18 where the categories operating, investing and financing are also used in the statement of profit or loss. It was mentioned above that the manner in which tax payments are presented in the statement of cash flows could be changed. However, a complete alignment may not be desirable. For example, input from users indicates that they would prefer depreciations to be included in the operating category in the statement of profit or loss, while the corresponding capital expenditures should be presented under investment activity in the statement of cash flows. As a complete alignment does not seem desirable, it could be considered to amend the categories in IFRS 18 and IAS 7 so that they would not carry similar names but have different content.

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

ES24 The DP presents a net debt statement as an alternative to the statement of cash flows. Some users consider a net debt statement more useful when, for example, estimating enterprise value. Some of the issues with the current statement of cash flows would be solved by instead requiring a statement of net debt. However, an issue with a statement of net debt is that there is currently no definition of net debt.

The statement of cash flows for financial institutions

ES25 As described in EFRAG's Discussion Paper *The Statement of Cash Flows: Issues for Financial Institutions* from 2015 and confirmed by the feedback received in response to that discussion paper, the relevance of the statement of cash flows of banks and insurance companies is questionable. This being said, there are, however, users who do use it.

ES26 Considering the questionable relevance of the statement of cash flows from financial institutions, alternatives could be considered. Examples of alternatives include: presentation of regulatory ratios (for banks); information about dividend payout capacity (for banks); information about the flow of regulatory capital (for banks); and standardised stress test scenarios (for banks and insurance companies).

Targeted improvements or a comprehensive review?

ES27 Many of the issues identified with the statement of cash flows could be addressed by targeted improvements. It could thus be expected that some of the current issues could be addressed within a relatively short time horizon. Targeted improvements may, however, not solve more fundamental issues, and the question therefore arises whether fixing some issues or comprehensively reconsidering the statement of cash flows (or something instead of a statement of cash flows) should be the way forward. This DP does not provide a preliminary view on this question but is encouraging stakeholders to provide their views on this and the other questions included in the DP.

QUESTIONS TO CONSTITUENTS

EFRAG invites comments on all matters in this Discussion Paper, particularly in relation to the questions set out below. Comments are more helpful if they:

- address the question as stated;
- indicate the specific paragraph reference to which the comments relate; and/or
- describe any alternative approaches that should be considered.

All comments should be received by [Submission date].

Question 1 Objectives of the statement of cash flows

Chapter 2 of this DP lists objectives of the statement of cash flows. The most important being:

- Evaluating the changes in net assets (Objective 1)
  - Understanding the entity's business (Objective 1a)
  - Assessing closeness to cash (Objective 1b.1)
  - Assessing current performance of the entity (Objective 1b.2)
- Assessing the entity's financial structure (Objective 2)
  - Assessing liquidity (Objective 2a)
  - Assessing solvency (Objective 2b)
- Assessing the entity's ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities (Objective 3)
- Assessing the ability of the entity to generate cash and cash equivalents (Objective 4)
- Comparing entities using different accounting treatments for the same transactions (Objective 5).
- Assessing management's stewardship (Objective 6)
  - Assessing management's general performance (Objective 6a)
  - Assessing management's cash management (Objective 6b)

Do you agree with these objectives? Do you think there are additional objectives?

As indicated in Chapter 4, solutions to some of the current issues with how the statement of cash flows is prepared in accordance with IAS 7 may benefit the usefulness of the statement of cash flows for some objectives while harm the usefulness of the statement for other objectives.

Do you think that some objectives of the statement of cash flows are more important than others? If so, which are more/less important?

Question 2 **Usages of the statement of cash flows**

In Chapter 3 the DP lists manners in which the statement of cash flows is used by primary users of the financial statements. Are there additional manners of using the statement of cash flows than those listed?

Question 3 **Issues with the statement of cash flows?**

Chapter 4 of the DP lists issues with how the statement of cash flows is prepared in accordance with IAS 7 and links these issues to the objectives they affect, and the qualitative characteristics of useful financial information affected. EFRAG has not made an assessment of the validity of the various stated issues.

Do you agree with the issues listed? Do you think there are additional issues than those listed? If so, which?

How would you rate the various issues identified (low, medium or high priority)?

Question 4 **Non-cash transactions**

Chapter 4 considers two types of non-cash transactions:

- Transactions in which no cash or cash equivalents are involved such as the acquisition of PPE by means of own shares
- Multiple components transactions that involve cash or cash equivalents, but which result in cash flows to and from an entity being reduced compared to a situation where the various components have not been bundled

Do you think that some non-cash transactions should be presented in the statement of cash flows? If so, which?

Instead of presenting non-cash transactions in the statement of cash flows, do you think additional disclosures should be provided about these transactions?

Question 5 Alternatives to the statement of cash flows for non-financial entities

Chapter 5 of the DP presents a statement of net debt (or a net debt reconciliation) as an alternative to the statement of cash flows. Would you support the statement of cash flows being replaced by a statement of net debt?

Question 6 The statement of cash flows for financial institutions

In 2015 EFRAG consulted on whether the statement of cash flows should be replaced by other requirements or should be improved. Do you consider that anything has changed since 2015 which would justify for this issue being reconsidered?

Question 7 Targeted improvements or a comprehensive review?

Chapter 7 shortly lists benefits and disadvantages of dealing with (some) of the issues with how the statement of cash flows is currently prepared under IAS 7 by targeted improvements, a comprehensive review or a phased approach, respectively.

Which approach would you prefer and why?

If you consider that the IASB should make targeted improvements, which issues do you think should/should not be addressed?

CHAPTER 1: BACKGROUND

Following the 2021 consultation on EFRAG's research agenda, EFRAG decided to include on its research agenda a project on the statement of cash flows. The project should be helpful for the IASB's project on the statement of cash flows and related matters. This Discussion Paper lists identified objectives and usages of the statement of cash flows and the related perceived issues with how statements of cash flows are currently prepared in accordance with IAS 7. The Discussion Paper also provide an assessment of whether the issues can be addressed by targeted improvements, or a comprehensive review of IAS 7 would be necessary.

Introduction

1.1 Following the 2021 consultation on EFRAG's research agenda, EFRAG decided to include on its research agenda a project on the statement of cash flows. The project aims to provide input to the IASB, which has also decided to include a project on its agenda following its Request for Information (RfI) on its Third Agenda consultation.

1.2 To be helpful for the IASB's project, it was deemed useful to identify the issues that currently exist for statements of cash flows prepared in accordance with IAS 7 *Statement of Cash Flows*. As perceived issues with the statement of cash flows would depend on how the statement of cash flows is used, EFRAG considered that objectives and usages of the statement of cash flows needed to be identified so that the identified issues would be linked to these objectives and usages.

1.3 Providing a list of perceived current issues with the statement of cash flows could give the impression that the IASB could solve these through targeted improvements. Therefore, EFRAG considered it necessary to discuss whether this would be the best approach to address the current issues or a comprehensive review of IAS 7 would be necessary to deal with the issues in a satisfactory manner.

Scope and objective of the Discussion Paper

1.4 The objective of this Discussion Paper ('DP') is to:

a) List identified objectives and usages of the statement of cash flows prepared in accordance with IAS 7.

b) List identified issues with the statement of cash flows prepared in accordance with IAS 7.

c) Discuss whether issues with the statement of cash flows can be addressed by targeted improvements or a comprehensive review of IAS 7 would be necessary to deal with the issues in a satisfactory manner.

1.5 When considering the objectives and usages of the statement of cash flows, only the needs of the primary users of general-purpose financial reports as described in the IASB's *Conceptual Framework for Financial Reporting* paragraph 1.5 (i.e., existing and potential investors, lenders and other creditors who must rely on general purpose financial reports for much of the financial information they need) are considered.

1.6 The DP does not provide assessments of identified objectives, usages and issues of/with the statement of cash flows. Accordingly, the DP may, for example, list examples of how the statement of cash flows is used, while some may consider to be an inappropriate use of the statement.

1.7 Input on the objectives, usages, and issues with the statement of cash flows has been collected from literature[1], interviews, closed and open outreach events. Although this DP in a few places includes indications of the frequency of which a given objective, usage or issues has been identified, it is not the purpose of the DP to provide statistical information on how often a given objective, usage or issue has been identified. The objective is instead to be as complete as possible in listing objectives, usages and issues related to the statement of cash flows, although these objectives, usages and issues may not be generally shared.

Structure of the Discussion Paper

1.8 This DP first lists the identified objectives of the statement of cash flows (Chapter 2) and then (in Chapter 3) presents some input collected by EFRAG from consultations with users of financial statements and from literature on whether the statement of cash flows is used for the objectives listed. This is followed by listing the issues, EFRAG is aware of, with how the statement of cash flows is currently prepared on IAS 7 (Chapter 4). As part of describing these issues, it will be considered which of the objectives of the statement of cash flows are affected by the issues and whether addressing the issue could potentially have consequences for the statement of cash flows' ability to meet other of the objectives listed in the DP. The DP does not claim that addressing an issue would necessarily have unwanted effects, however, it marks issues that might arise depending on how an issue would be addressed.

1.9 As noted in EFRAG's Discussion Paper *The Statement of Cash Flows, Issues for Financial Institutions*, and confirmed by the feedback received during the consultation period, a generally held view is that the statement of cash flows is not useful for financial institutions. Chapter 5 accordingly considers separately the statement of cash flows for financial institutions.

1.10 For both non-financial entities (corporates) and financial institutions, some of the input collected suggests that there may be alternatives to the current statement of cash flows that could provide more useful information in some cases. These alternatives are presented separately in Chapter 6.

1.11 Chapter 7 includes a discussion on whether the identified issues can be dealt with through targeted improvements, or a comprehensive review of IAS 7 would be necessary to address the issues in a satisfactory manner.

[1] Some of the input collected for this DP has been collected by Zielke Research Consult.

CHAPTER 2: OBJECTIVES/PURPOSE OF THE STATEMENT OF CASH FLOWS FROM NON-FINANCIAL ENTITIES

This Chapter lists different objectives of the statement of cash flows. There are different manners in which the objectives of the statement of cash flows could be listed. As the purpose of this DP is to list issues with IAS 7, it has been chosen to consider as objectives, the benefits of cash flow information presented in the Conceptual Framework for Financial Reporting and IAS 7 which are considered to be: evaluating changes in net assets; assessing the entity's financial structure; assessing the entity's ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities, assessing the ability of the entity to generate cash and cash equivalents; and comparing entities using different accounting treatments for the same transactions and events.

Benefits of cash flow information

2.1 The objective of the statement of cash flows is often stated by reference to what it shows, for example:

a) The primary objective of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an entity during a period[2].

b) The statement of cash flows shows where an entity got its money from and what it did with the money[3].

2.2 Neither the IASB Conceptual Framework for Financial Reporting nor IAS 7 thus state a clear objective of the statement of cash flows. Instead, they explain how the information included in the statement of cash flows can be useful.

Conceptual Framework for Financial Reporting

2.3 According to paragraph 1.2 of the Conceptual Framework for Financial Reporting (the 'Conceptual Framework')

> [t]he objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.

2.4 Paragraph 1.3 of the Conceptual Framework explains that the decisions relating to providing resources to the entity depend on the returns that existing and potential Investors, lenders and other creditors expect. Expectations on returns depend on:

a) an assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity; and

b) an assessment of the management's stewardship of the entity's economic resources.

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2 ACS 230-10-10-1.

3 Comment made at an EFRAG round table on the statement of cash flows.

2.5 To form these expectations and assessments, existing and potential investors, lenders and other creditors need, according to par. 1.4 of the Conceptual Framework, information about:

a) the economic resources of the entity, claims against the entity and changes in those resources and claims;

b) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources.

2.6 The Conceptual Framework notes (paragraph 1.12) that information about:

a) an entity's economic resources and the claims against the reporting entity; and

b) the effects of transactions and other events that change a reporting entity's economic resources and claims

is useful for the information need described in paragraph 2.5a) above.

2.7 On the usefulness of reporting an entity's cash flows during a period, the Conceptual Framework considers (paragraph 1.20), that this information helps users to assess both of information needs listed in paragraph 2.5 above. It is noted that the statement of cash flows

> indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance.

IAS 7

2.8 IAS 7 states that the objective of the Standard (not the objective(s) of the statement of cash flows) is to:

> […] require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities.

2.9 Similar to the Conceptual Framework, IAS 7 explains why the information provided in the statement of cash flows is useful. Under the heading 'objectives' it states that:

> Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the need of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation.

2.10 Under the heading 'Benefits of cash flow information' paragraph 4 of IAS 7 further states that[4]:

[4] For the US, ACS 230 states that the "information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others (including donors) to do all of the following: a. Assess the entity's ability to generate positive future net cash flows b. Assess the entity's ability to meet its obligations, its ability to pay dividends, and its needs for external financing c. Assess the reasons for differences between net income and associated cash receipts and payments d. Assess the effects on an entity's financial position of both its cash and noncash investing and financing transactions during the period." (ACS 230-10-10-2)

A statement of cash flows, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the entity to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different entities. It also enhances the comparability of the reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for the same transactions and events.

Deduced objectives

2.11 A few differences can be observed between the benefits of the statement of cash flows as stated in the Conceptual Framework versus IAS 7. The Conceptual Framework does thus not explicitly refer to the usefulness of the statement of cash flows in relation to assessing the entity's ability to affect the amounts and timing of cash flows to adapt to changing circumstances and opportunities and for comparing entities. These objectives could, however, be included in the more general references in the Conceptual Framework, including in 'other information about financial performance'.

2.12 Based on both the Conceptual Framework and IAS 7, it might be deducted that the statement of cash flows does have a separate purpose, but its purpose is, together with other information in the financial statements to provide information that is useful for:

<u>Assessment of the amount, timing and uncertainty of future net cash inflows</u>

a) Evaluating the changes in net assets (including evaluation of performance) (Objective 1);

b) Assessing the entity's financial structure, including (Objective 2):

(1) Liquidity; and

(2) Solvency;

c) Assessing the entity's ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities (Objective 3);

d) Assessing the ability of the entity to generate cash and cash equivalents (including cash dividends and other cash to investors) (Objective 4);

e) Comparing entities as it eliminates the effects of using different accounting treatments for the same transactions and events (Objective 5);

<u>Assessment of the management's stewardship</u>

f) Assessing management's stewardship (Objective 6).

2.13 These purposes, which are related, are further explained below. At the end of this chapter, it is also described how the listed objectives relate to the two information needs stated in paragraph 2.4 above.

2.14 Changes in cash and cash equivalents and changes in net assets generally, could, to some extent be estimated based on the statement of financial position and the statement of financial performance. However, some academic research has found that the statement of cash flows provides additional information than the information that can be derived from the other two primary financial statements[5].

Objective 1: Evaluating the changes in net assets

2.15 Stated in a simplified manner, one of the objectives of the statement of cash flows is to explain why an entity's cash position has not changed with the same amount as the profit or loss for the period. The statement thus provides a link to the statement of financial performance and to the statement of financial position.

2.16 The statement of cash flows shows, for the period between two accounting periods, the sources from which the entity has received its resources (for the statement of cash flows: its cash and cash equivalents) and how it has used these resources (cash and cash equivalents). This information can be used for:

a) understanding the entity's business (Objective 1a)

b) assessing accruals (Objective 1b)

Objective 1a: Understanding the business

2.17 As mentioned above, the statement of cash flows provides information on the sources of the entity's resources. For example, does the entity generate the resources it uses for maintaining its business or for growing from its operations, from selling its fixed assets or from obtaining new debt or, for example, from requiring payments from customers in advance and paying suppliers in arrears. This information is useful for understanding the business.

2.18 The statement of cash flows can also provide information about at which stage in its life cycle an entity is at[6]. Negative free cash flows may indicate that the entity is at the growth stage. This can be associated with the high capital expenditures and other investments. Mature entities, on the other hand, have positive free cash flows, whereas entities which are at the declining stage have lower levels of capital expenditures, which increase the positive free cash flows[7], however, operating cash flows may also decrease as the entity may have to lower the prices of its products.

2.19 Information about which stage of its life-cycle an entity is at can, for example, help users of financial statements to[8]:

a) better assess growth rates and forecast horizons in valuation models;

b) better understand how economic fundamentals affect the level and convergence properties of future profitability; and

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[5] See, for example, Mitchell et al. (1995).

[6] The life cycle of an entity may composite of many overlapping, but distinct product life cycle stages.

[7] Greuning et al. (2013).

[8] Dickinson (2011).

c) identify firms where potential unidentified risk factors and/or market mispricing exist based on differences in life cycle stage.

2.20 The statement of cash flows can also provide information on the 'dynamics'/'rhythm' of a business including its cash conversion cycle and if prepared for interim reporting periods, information on seasonality in cash inflows and outflows.

Objective 1b: Assessing accruals

2.21 The statement of cash flows can be used for assessing accruals. This can comprise both:

a) Assessing the closeness of earnings to cash (Objective 1b.1). Such assessments can support assessments of how representative earnings figures are for future earnings. This is also sometimes referred to as assessing the sustainable earnings power or as assessing the quality of earnings, but the term 'quality of earnings' has several meanings.

Information on accruals can also be estimated using information in the statement of financial position. Academic research, however, indicates that investors use accrual information more efficiently when the information is also provided by a statement of cash flows, particularly less sophisticated users seem to benefit from this information[9].

b) Assessing the current performance of an entity (Objective 1b.2). As noted in relation to Objective 1a, the statement of cash flows can be used to understand the entity's business, but it can also be used to assess the performance. For example, has the entity become more effective in collecting receivables and has the contract liabilities increased or decreased (indicating increases/decreases in future revenue (or problems fulfilling contracts).

Objective 2: Assessing the entity's financial structure

2.22 The statement of cash flows can provide information about an entity's financial position. The information related to the financial position of an entity is important because it enables investors to understand whether an entity has potential to generate future net cash flows which will be used in meeting the various types of financial obligations, the ability to return money to investors and assess whether there is a need for the entity to avail external sources of finance in order to fund operations[10].

2.23 Information about the entity's financial position is provided by presenting the related cash inflows and cash outflows under cash flow from operating activities, cash flow from investing activities and cash flow from financing activities. Cash flow information provided in this manner explains how an entity has used the financial resources in the form of cash outflows and how an entity has been able to accumulate financial resources in the form of cash inflows. This information enables users of the statement of cash flows to evaluate both the liquidity and solvency position of an entity by using relevant cash flow ratios suitable for assessing liquidity and solvency respectively[11].

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[9] See Miao et al. (2016).

[10] See, for example, Munther (2023).

[11] See, for example, Gebhardt & Mansch (2012) and Noor et al. (2012).

Objective 2a: Assessing liquidity

2.24 The term 'liquidity' may be understood slightly differently by different persons. It can be understood as how easily an asset can be exchanged for cash[12] (Objective 2a.1) or the amount of cash or liquid assets a company has easily available[13] (which can be used to meet its financial obligations) (Objective 2a). Under the latter, liquidity is thus the ease with which an entity can meet its financial obligations with the available liquid assets and be able to pay off debts as they come due[14]. Liquidity is a function of cash flows and is appropriately evaluated using cash ratios from the statement of cash flows as traditional liquidity ratios do not reflect the cash available for an entity to meet its financial obligations.

2.25 Having relatively many liquid assets could benefit the entity's solvency and agility/adaptability. Indeed, even fundamentally sound business will find it extremely difficult to survive in the short without liquidity. However, liquid assets may produce a lower return than less liquid assets.

2.26 Some academics[15] have compared financial ratios related to liquidity assessments (in the meaning of meeting short-term financial obligations) based solely on information in the statement of financial position and the statement of profit or loss with ratios considering also information from the statement of cash flows. For example, the ratio: current assets over current liabilities has been compared to the ratio: cash flows from operating activities over current liabilities. The academics consider 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. The major benefit of cash flow ratios is that these consider the resources the company has generated to meet its payment commitments over a period of time and not how much cash the company had available at a point in time.

Objective 2b: Assessing solvency

2.27 Like 'liquidity', 'solvency' may also be understood slightly differently. For example, for some it is related to (the market value of) assets over liabilities (when this ratio is less than one, the entity is insolvent) (Objective 2b.1) for others, it relates to the entity's ability to pay its debt[13] when due[16] (Objective 2b). In the latter case, evaluating solvency is assessing the risk that an entity will not be able to raise sufficiently cash before its debts must be paid[16]. Information that provides insight into the amounts, timings and uncertainty of an entity's future cash receipts and payments is useful in evaluating solvency[17]. As the statement of profit or loss does not address the timing of cash flows (unless it affects the 'value' of the consideration), the statement of profit or loss only provides limited information on this.

2.28 An entity can have a high amount of liquid assets but have issues with its solvency because the debt it will have to pay is even higher.

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[12] See, for example, Oxford Learner's Dictionaries (https://www.oxfordlearnersdictionaries.com/definition/english/liquidity?q=liquidity – Accessed 23/02/2024).

[13] See, for example, Collins Cobuild Advanced Learner's English Dictionary.

[14] See Hayes (2024).

[15] See, for example, Billah et al. (2015).

[16] See, for example, Heat (1978).

[17] Heat & Rosenfield (1987).

2.29 Although the assessment of solvency may seem to be particularly relevant for credit analysts, equity holders would also have an interest in the information as equity investors are likely to lose even more if the entity would become insolvent[16].

2.30 Although there has been academic evidence that cash flows from operation-based ratios are incrementally useful for predicting bankruptcy beyond the information contained in accrual-based ratios[18], other results indicate that during periods of financial distress operating profit is a better predictor of future solvency than earning figures[19]. In addition, similar to the studies comparing financial ratios related to liquidity assessments mentioned in paragraph 2.26 above, ratios related to solvency have also been assessed with the same recommendations being put forward[15].

Objective 3: Assessing the agility/adaptability of the entity

2.31 An entity's ability to react to opportunities and threats is improved if its actions can be done without having to raise financing. If an entity is not able to make investments (expected to be profitable), it can affect its long-term profitability[16].

2.32 When considering requiring detailed information on an entity's current operating cash flows, the FASB[20] thus noted that 'the greater the amount of future net cash inflows from operations, the greater the ability of the enterprise to withstand adverse changes in operating conditions'.

2.33 Information on the cash flows available after debt is being serviced could therefore be useful for the assessment of an entity's agility/adaptability.

Objective 4: Assessing the ability of the entity to generate cash and cash equivalents

2.34 The assessment of the entity's ability to generate cash and cash equivalents is an important part of the information needed to assess the amount, timing and uncertainty of future net cash inflows.

2.35 It follows from paragraph 1.20 of the Conceptual Framework that

> [i]nformation about a reporting entity's cash flows during a period also helps users to assess the entity's ability to generate future net cash inflows.

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[18] Casey and Bartzcak (1985). The study was based on 'calculated cash flows from operations' and not cash flows from operations as reported in the statement of cash flows. Also, the study found that cash flows from operation-based ratios were useful for predicting bankruptcy (1–5 years prior to the bankruptcy) but did not represent any incremental usefulness compared to accrual-based ratios.

[19] Allen & Cote (2005).

[20] Referred in Casey & Bartczak (1985).

2.36 Following a statement in the FASB's Statement of Financial Accounting Concepts No. 1 (from November 1978) that information about earnings and its components is generally more predictive of future cash flows than current cash flows, academic literature has examined whether 'accrual accounting', as reflected in the statement of financial performance seems more useful for predicting future cash flows than past cash flows[21]. Academic literature generally indicates that cash flows is useful in predicting an entity's future cash flows and, although it may[22] or may not[23] on a stand-alone basis be better than the statement of performance, then it can provide additional information to the information included in the statement of financial position and the statement of financial performance[24]. Academic studies also show that information in the statement of cash flows is more useful for this objective than the cash flow information, users of financial statements would be able to derive themselves from the statement of financial position and the statement of financial performance. In addition, there have been some indications that cash flow components related to core operating cash flows (such as sales, cost of goods sold and general and administration expenses) are more predictive for future cash flows than non-core operating cash flows[25].

2.37 A number of academic studies have investigated the association of accounting figures with the market value of an entity and how well these figures are at explaining the market value (or changes in this). If information increases in the explanatory power for market values (or changes in this), it is assessed that the information provides information that is useful to investors. Based on this, some studies thus conclude that the statement of cash flows provide useful information[26].

2.38 Independently on how useful the statement of cash flows is for assessing the ability of the entity to generate cash and cash equivalents, it could be argued to be useful for checking whether previous estimates on this were correct.

Objective 5 Assessing the effects of different accrual accounting practices

2.39 As the reporting of cash flows in principle[27] does not depend on accrual accounting practices, the cash flow statement of different entities could be used to compare the financial performance of entities applying different accounting practices (for the statement of profit or loss and the statement of financial position).

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[21] See, for example, Finger (1994). This study finds that cash flow from operations is better at predicting cash flow from operations in the short term while for longer horizons, cash flows and earnings are approximately equivalent.

[22] See, for example, Nallareddy et al. (2020). This study finds that operating cash flows (using data from the statement of cash flows) outperforms income before extraordinary items and discontinued operations to predict future operating cash flows.

[23] See, for example, Dechow et al. (1998). This study finds earnings to be a better forecast of future cash flows than current cash flows.

[24] See, for example, Barth et al. (2001). This study finds that disaggregating earnings into cash flow and the major components of accruals significantly enhances earnings' predictive ability.

[25] See, for example, Cheng & Hollie (2008).

[26] See, for example, Akbar et al. (2011) and Mostafa et al. (2013) for UK data.

[27] Following the IFRIC 2008 Agenda Decision to recommend to the IASB that IAS 7 should make explicit that only an expenditure that result in a recognised asset can be classified as a cash flow from investing activity, accrual accounting practices could have an impact on how cash flows are classified.

2.40 Although IAS 7 does not mention it directly, it seems implicit that the statement of cash flows can also be used to identify earnings management. This can be done by assessing whether changes in accruals seem abnormal. Increases in contract assets or

2.41 When the cash flows from operating activities are presented using the direct method, the differences between, for example, revenue from customers and cash received from customers can be compared. When the indirect method is used changes in, for example, account receivables can be assessed.

Objective 6 Assessing management's stewardship

2.42 As stated in the Bulletin Getting a Better Framework – Accountability and the objective of financial reporting (EFRAG et al. 2013).

> [o]ne of the main arguments for providing information on accountability [which is used as a synonym for stewardship] is that it enables investors to oversee management behaviour. Although management are appointed by the shareholders, the interests of management and shareholders may diverge. For example, management may have an incentive to undertake risky investments where their entitlement to bonus payments is linked to profits but they do not share in any losses. Or management may prefer to avoid the work that would be required by restructuring the business. Financial statements that fulfil an accountability objective can assist shareholders in detecting where the business is not being managed in accordance with their objectives.

2.43 The statement of cash flows can be used to assess the management's:

a) general performance (Objective 6a); and

b) cash management (Objective 6b).

2.44 The statement of cash flows can be used for the general assessment of the performance of the management (Objective 6a) and specifically for the cash management (Objective 6b).

2.45 For the general performance assessment, cash flows from operating activities can be essential. The amount of cash flows from operating activities exerts a strong influence over corporate financing and investment decisions. Entities must rely on cash flows from operating activities to repay debt, pay dividends, fund operations, and finance investments (especially when external funds are costly)[28].

2.46 There are several aspects of stewardship:

a) responsibility of entrusted resources;

b) whether a reasonable return from entrusted resources is generated; and

c) which risks are undertaken to generate return on investment.

[28] Nwaeze et al. (2006).

2.47 The statement of profit or loss and the statement of financial position provide information for the assessment of the management's responsibility of entrusted resources. The statement of cash flows can, however, provide additional information. In the most extreme cases, the statement of cash flows can thus help in identifying whether the information presented in the statement of profit or loss and statement of financial position can be trusted. This can be done, for example, by assessing accruals (see Objective 1b). Similar to how the statement of cash flows can be used to compare the performance of an entity with its peers when assessing the amount, timing and uncertainty of future net cash inflows (Objective 5), the statement of cash flows can be used to assess the managements in a manner that is not affected by the use of particular accounting treatments. In this regard, the statement of cash flows can also be used to identify earnings management and fraud. The value relevance of the statement of cash flows for stewardship assessments is also evidenced by the use of cash flow measures when determining management's remuneration[29].

2.48 The statement of cash flows can also be used to assess whether a reasonable return from entrusted resources is generated. The statement of cash flows can thus be used to assess whether the entity is able to generate as much cash from operating activities as its peers.

2.49 For the assessment of risk, information about the entity's agility (Objective 3) and its investments (CapEx) is, among other things, useful.

2.50 For the cash management, the statement of cash flows can provide information on whether there are significant fluctuations in the amount of cash and cash equivalents; whether the entity 'suddenly' has to take up loans to finance acquisitions/growth; whether the entity is paying dividends despite cash deficits in operating activities and/or financing dividends through long-term loans. The statement of cash flows can also tell whether the management 'keeps' control of generated cash by investing this or transfers the control by paying dividends to its shareholders.

2.51 Although the deduced objectives have been divided between objectives related to the assessment of the amount, timing and uncertainty of future net cash inflows and the assessment of management's stewardship, it has appeared from the above that information listed for objectives 1–5 can also be useful for the assessment of stewardship. Similarly, as stated in paragraph 1.22 of the Conceptual Framework, information about the entity's stewardship can be useful for assessing the entity's prospects for future net cash inflows.

[29] Nwaeze et al. (2006) and Natarajan (1996).

CHAPTER 3: USAGES OF THE STATEMENT OF CASH FLOWS FROM NON-FINANCIAL ENTITIES

This chapter provides some insight into whether the statement of cash flows is used for the objectives listed in Chapter 2 above. The chapter is based on input collected by EFRAG at various outreach events, consultation with EFRAG working groups and academic literature. EFRAG notes that the input it has collected may not be generalisable. There is some evidence that the statement of cash flows is used for most of the objectives listed in Chapter 2. However, both the input collected by EFRAG as well as academic literature could indicate that users have differing views on the value of the information included in the statement.

General usage

3.1 Input collected by EFRAG supports that the benefits of the statement of cash flows arise when the statement is used in conjunction with the rest of the financial statements.

3.2 The input collected, however, also shows variation in the usages of the statement of cash flows by users of financial statements – including the same types of users. Some users do thus not use the statement of cash flows or barely use it[30], while others use it more extensively. Also, some input collected suggests that some users are more likely to pay attention to the information in the statement of cash flows if the financial health of a given entity is poor, compared to when it is good.

3.3 As noted in paragraph 2.14 some academic research has found that the statement of cash flows prepared by entities provide additional information to the information that can be derived from the information included in the statement of financial performance and the statement of financial position. In addition, EFRAG has heard from users that the benefit of the statement of cash flows is that the information is more easily available compared to if users should have tried to derive it from the other parts of the financial statements.

Objective 1: Evaluating changes in net assets

3.4 Input collected by EFRAG indicates that the statement of cash flows is used to evaluate changes in net assets. Surveys conducted in the US and Australia have found similar evidence.

3.5 FASB Investor Survey in 2022 showed that majority of investors responding agreed that the current statement of cash flows (in the US) provides information needed for analysing changes in working capital (FASB 2023b).

3.6 An older academic study based on an Australian survey[31] similarly found that preparers of financial statements considered that the information presented in the statement of cash flows would be useful for investors for monitoring changes in the financial position.

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[30] Examples of a very light use of the statement, includes users who only use the information in the statement on capital expenditures or taxes paid.

[31] Jones and Ratnatunga (1997).

Objective 1a: Understanding the business

3.7 The input collected by EFRAG has indicated that the statement of cash flows is used by some to understand 'the rhythm', cash flow dynamics[32], business cycle of an entity, the stage at which an entity is in its life cycle and the cash conversion. In the IFRS Foundation's Investor Perspective, IASB member Nick Anderson has thus also stated that:

Experienced analysts and portfolio managers would often advise those new to the profession to 'follow the cash and you will understand the business' Anderson (2023).

3.8 The information included in the statement of cash flows, together with information about movements in debt, can be used to understand the sources of an entity's finance and how those sources have been used over time[33].

3.9 Understanding the business is relevant for both assessing the entity's ability to service debt and for investment decisions[33].

3.10 Literature also suggests that some use information on capital expenditures, which appear from the statement of cash flows, to assess the capital intensity of an entity[34]. Capital intensity is then calculated as, for example, capital expenditure divided by revenue. The capital intensity is then used to assess how much an entity relies on tangible versus intangibles. It is considered that entities relying on physical assets like real estate, factories and machinery are unlikely to earn reliably superior returns on their invested capital over the long term[34].

3.11 Although the statement of cash flows is used to provide insight of an entity's life cycle, research indicates that the market does not fully capture information provided by the life cycle proxy such that mature entities earn positive excess returns in the year following life cycle stage assignment. This might indicate that investors underestimate the persistence of the elevated profitability of mature firms and instead expect their profitability to mean-revert to a 'normal' level[35].

Objective 1b: Assessing accruals

3.12 Input received by EFRAG from users has confirmed that the statement of cash flows is used by some users to assess the how sustainable reported earnings is (e.g., the closeness to cash). Some users thus consider increases in accruals as a 'red flag'. For example, if increases in operating or net profit is reported but cash flows from operating activities have not increased. The Enron case has sometimes been referred to as an illustration of why it is important to consider the sustainability (or quality) of reported earnings.

3.13 The Australian study previously mentioned[31], found that the statement of cash flows provided useful information for lenders for assessing overall company performance, operating performance and the quality of net income. This also applied to the usefulness for investors with the exception that the assessments of the usefulness for assessing the quality of net income were not significant.

[32] Input collected by EFRAG and mentioned by Anderson (2023).

[33] Anderson (2023).

[34] Elmars (2007).

[35] Dickinson (2011).

3.14 Although the statement of cash flows is used by some users to assess accruals, some academic studies indicate that high levels of accruals are not reflected in sell-side analysts' earnings forecasts[36] and investors over-estimate the persistence of the accrual component of earnings and under-estimate the persistence of the cash flow component of earnings. Accordingly, a trading strategy with a long position in low accrual firms and a short position in high accrual firms generates significant abnormal returns in the subsequent years[37].

3.15 Similarly for credit providers, an academic experimental study indicates that information in the statement of cash flows is considered less than information in the statement of profit or loss[38].

Objective 2: Assessing the entity's financial structure

3.16 Information in the statement of cash flows is, together with other information, used to assess the financial robustness of an entity, including its credit worthiness[39]. It is used to assess whether an entity has generated enough cash inflows to meet its short-term and long-term debt obligations. The information is also important for bond analysts to enable them to assess whether an entity's liquidity position would be strong enough during the next refinancing period to attract funds.

3.17 The information included in the statement of cash flows, together with information about movements in debt, can be used to better assess a company's ability to service and repay its debts[33].

3.18 Academic literature[40] notes that the cash flow analysis is the most important single factor for credit rating decisions[41]. In addition to aiding in determining the trends and sustainability of cash flow generation, it is used to separate cash flows from operating activities, from investing activities and financing activities and to identify potential distortions and future volatilities.

3.19 Debt analysts and rating agencies use a number of ratios, which are also found in loan agreements. However, instead of using figures from the statement of cash flows credit analysts as well as agencies usually prefer EBIT and EBITDA[40]. For example, to assess the repayment period (if operating cash flows is used exclusively for debt repayment), the ratio net debt (the difference between interest-bearing liabilities and cash and cash equivalents) over EBITDA is used. Similarly, to assess the interest coverage ratios EBIT or EBITDA are related to the interest expense[40]. However, an alternative to assess the repayment period, from which figures from the statement of cash flows is also seen. Under this alternative operating cash flows before changes in working capital (funds from operation) is also used instead of EBITDA[40].

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[36] See Bradshaw et al. (2001).

[37] See, for example, Ahmed et al. (2006) and Livnat (2006).

[38] Allen & Cote (2005).

[39] Information collected by EFRAG.

[40] Gebhardt & Mansch (2012).

[41] As noted in paragraph 3.15, academic literature, however, also indicates that creditors focus more on earnings figures than on cash flow figures.

3.20 The Australian study previously mentioned[31], found that the statement of cash flows provided useful information for lenders for evaluating solvency, ability to service debts and liquidity. For investors it was assessed to provide useful information on liquidity. The study did not provide significant results on whether the statement was considered useful for investors to evaluate solvency and the ability to service debts.

Objective 3: Assessing the agility/adaptability of the entity

3.21 When EFRAG discussed the usage of the statement of cash flows with users of financial statements, the objective of assessing an entity's agility/adaptability was seldom mentioned, and when it was mentioned, it was in relation to assessing whether additional finance would be needed for the entity to grow.

3.22 Academic literature[42], also, notes that for debt analysts and creditors, information on liquidity and financial flexibility of an entity, especially in times of difficult access to the credit and bond markets, is important for credit decisions. Although these analyses may be based on current freely available funds and expected future changes in these, debt analysts and rating agencies require information for forward-looking analyses which is only partially provided in annual reports. This includes information on the accessibility and structure of liquid funds, the quality of unused committed credit lines, the time structure of future liquidity outflows, contingent liabilities and a breakdown of current financial liabilities by type of debt instrument.

3.23 The Australian study mentioned several times above[31], found that the statement of cash flows provided useful information for lenders for evaluating the ability to fund changes in the scope and nature of operations and the ability to obtain external finance. For investors, the study found that the statement of cash flows was considered to provide useful information for the entity's capacity to adapt to changing conditions.

3.24 Academic research indicates that entities with positive changes in available cash liquidity are more likely to make investments[43].

Objective 4: Assessing the ability of the entity to generate cash and cash equivalents

3.25 As it appeared from Chapter 2, an objective of the statement of cash flows is that it should be useful for the valuation of an entity when applying a discounted cash flow model.

3.26 Input collected by EFRAG confirms that information included in the statement of cash flows is actually used when valuing entities based on, for example, free cash flow to equity (for estimating equity value) or free cash flow to the firm (for estimating enterprise value).

3.27 The information included in the statement of cash flows can thus be used to analyse a company's underlying operating cash flows and free cash flow generation[44].

[42] Gebhardt & Mansch (2012).

[43] See, for example, Beatty et al. (1997) and Lewellen & Lewellen (2016) for studies on US entities.

[44] Anderson (2023).

3.28 As noted by Gebhardt & Mansch (2012) and confirmed by input collected by EFRAG, equity analysts often use their own methods to determine and estimate cash flows, which include reconstructing the statement of cash flows. Alternative approaches used[45] include discounting expected future dividends and estimating enterprise value based on changes in net debt[46]. Information from the statement of cash flows can, together with information about movements in debt, be used to reconcile changes in net debt (from opening to closing balance) [47].

3.29 Although users try to estimate future cash flows, they may rely more on information in the statement of profit or loss and changes in assets and liabilities than from the figures reported in the statement of cash flows. In these cases, however, the input collected by EFRAG, indicates that often capital expenditures from the statement of cash flows is used for these estimates. Even when future cash flow projections are mainly based on figures from the statement of profit or loss, such as operating profit, the information included in the statement of cash flows on capital expenditures is often included (subtracted) after depreciations and amortisation expenses have been added back. In addition, information on capital expenditures is compared with amortisation and depreciation cost included in the statement of profit or loss to assess growth (potentials) of the entity. This comparison could thus indicate whether the entity is investing more (or less) than the recognised assets it is consuming.

3.30 Gebhardt & Mansch (2012) notes that even though equity analysts do not base their estimations of future cash flows on the statement of cash flows, the statement of cash flows is used to assess how good previous estimates of future cash flows were. The information included in the statement of cash flows, together with information about movements in debt, can thus be used to improve confidence in forecasting a company's future cash flows[33].

3.31 In addition, the information from the statement of cash flows is used to gain future insight in the entity when estimating future cash flows.

3.32 As mentioned in paragraph 3.12, the statement of cash flows is thus used to assess the sustainable power of earnings. Input collected by EFRAG indicates that this information is also used by some when estimating future cash flows.

3.33 Paragraph 2.44 listed that the statement of cash flows can be used to assess how dividends are 'financed'. This information is also used by equity analysts who consider the dividend coverage ratio[48] showing the percentage of dividends payments that are backed by a good operating cash flow development[45]. The payout ratio is often used to determine the sustainability of dividends[49]. Low values are used to call into question future dividend payments of the same amount[45].

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[45] Gebhardt & Mansch (2012).

[46] Input collected by EFRAG.

[47] Anderson (2023).

[48] Cash flows from operating activities / dividend payment.

[49] Arnold et al. (2018).

3.34 Information on capital expenditures in the statement of cash flows is also used to assess whether the entity is investing sufficiently for the expected growth rate to be realistic. Similarly, the statement of cash flows is used to assess whether the entity can be expected to run into liquidity issues in the future, and thus indicate whether costs of additional finance should be included in the future cash flow estimations.

3.35 It has been noted that information of the entity's ability to generate cash from operations has become more important in Europe for users to estimate future cash flows following the decision of many entities to no longer preparing market outlooks for investors.

3.36 The Australian study mentioned above[31], found that the statement of cash flows was considered to provide useful information for lenders and investors for predicting future cash flows and monitoring fixed assets.

Objective 5: Assessing the effects of different accrual accounting practices

3.37 The ability to compare financial statements prepared under different accrual accounting practices was not a point of focus by the users of financial statements from which EFRAG has received input.

3.38 However, as it was mentioned in relation to Objective 1, the statement of cash flows is used to assess whether accruals are increasing. There can be many reasons for increasing accruals, but one reason could be that earnings management is carried out, and users have mentioned this as something the statement of cash flows can help identify[50].

3.39 The Australian study mentioned above[31], found that the statement of cash flows was considered to provide useful information for lenders and investors for comparing the performance of an entity with the performance of other entities.

Objective 6: Assessing management's stewardship

3.40 Input collected by EFRAG indicates that the statement of cash flows is used by some to assess both the general performance of the management (Objective 6a) and its cash management (Objective 6b).

3.41 In relation to the general performance of the management, the input collected by EFRAG reflected that the statement of cash flows was both used for an overall assessment of the management and for specific assessments. It was thus used overall to assess what the management has accomplished in terms of the plans and objectives set and specifically for the assessments of whether investments have paid off and how the cash flows from operating activities have been used. Information on capital expenditures is thus used, together with information included in the statement of profit or loss, to assess whether past capital expenditures have paid off. On the usage of cash flows from operating activities, it was noted that management has the discretion of using the cash flow from operating activities to either undertake reinvestment decisions or pay dividend. Therefore, the decision of management to use the cash flow from operating activities in paying for dividends or reinvestment also helps understand management stewardship.

[50] Cooper & Jullens (2024).

3.42 In relation to the management's cash management, the statement of cash flows is used to assess whether the entity has the money it is spending.

3.43 The Australian study mentioned above[31], found that the statement of cash flows provided useful information for investors and lenders for evaluating managerial performance.

CHAPTER 4: ISSUES FOR NON-FINANCIAL ENTITIES

This chapter lists the issues for non-financial entities with the statement of cash flows prepared in accordance with IAS 7 that have been brought to the attention of EFRAG. This means that EFRAG does not necessarily agree with all the issues listed. For the issues listed, it has been assessed which of the objectives listed in Chapter 2, the issues relate, the qualitative characteristics of useful financial information that are affected and which of the objectives listed in Chapter 2 that could be aversively affected by solving the issue. The issues are categorised based on whether they are related to: which transactions should be included/excluded; how cash flows are classified; presentation of cash flows from operating activities (the direct versus the indirect method); insufficient disclosures; the need for further aggregated information and cohesiveness with other financial statements.

4.1 IAS 7 is an old Standard and substantial modifications have been limited since it was first issued in 1992. Some argue that the statement of cash flows in its current form has not kept pace with changes in financial reporting practices, evolving business environments and non-traditional transactions. Therefore, the Standard does not provide clear requirements for certain transactions or with its interaction with other IFRS Accounting Standards. In addition, IAS 7 includes various options and may not be considered to be particularly prescriptive in relation to presentation.

4.2 This chapter deals with the issues identified on how the statement of cash flows is currently prepared under IAS 7. The list is a 'gross list' meaning that it includes issues brought forward. However, EFRAG has not made an assessment on whether it would agree with all the items listed being considered 'issues'. The identified issues are classified into the following categories:

a) Issues with included/excluded transactions

b) Issues with classification

c) Presentation of cash flows from operating activities

d) Insufficient disclosures

e) Need for more disaggregated information

f) Definitions

g) Cohesiveness with the other Financial Statements

4.3 For many of the listed categories there are issues both with divergence in practice/different interpretations of the requirements, with the understandability of the information and with the relevance of the information the current requirements result in.

4.4 Divergence in practice affects comparability of information between entities. This directly affects the relevance of the statement of cash flows for assessing the effects of different accrual accounting practices (Objective 5) and the comparability of the information between different entities of the other objectives. The different practices/the different interpretations would also generally result in outcomes that would result in information being more or less relevant for a particular outcome. It is, however, outside the scope of this DP to assess these outcomes.

4.5 For the issues where it is considered that the current requirements do not result in the most relevant information, this DP provides an assessment of the objectives for which the current requirements may not result in the most useful information. It also notes which objectives could potentially be adversely affected by amending IAS 7 in a manner that would address the issue. Table 1 below provides an overview of these. The table thus highlights areas where the various deducted objectives of the statement of cash flows may be competing, and it has to be decided which objective(s) are the most important.

Table 1 – Identified issues where it is considered that the current requirements of IAS 7 does not result in the most relevant information.

Issue	Particular relevant for	Qualitative characteristics mainly affected {potentially adversely affected by a solution}
Issues with included/excluded transactions		
Requirements on which items should be considered cash equivalents are too restrictive (could consider items that could be converted into cash in a six- months period)	Objectives: 2b; 6b	Relevance
	Objective: 2a	{Relevance}
Requirements on which items should be considered cash equivalents are not sufficiently restrictive. Only cash that is readily available should be included.	Objective: 2a	Relevance
	Objectives: 2b; 6b	{Relevance}
Certain non-cash transactions (e.g., payments in own shares or sales in crypto currencies) should be included in the statement of cash flows.	Objectives: 1a; 4; 5; 6a	Relevance {Faithful representation)
	Objectives: 1b.1; 2; 3; 4; 5; 6b	{Relevance} {Faithful representation)
Certain non-cash transactions should be included in the statement of cash flows (e.g., payments that do not occur in a multiple-component transaction but would have occurred if the various components would have been carried out by different parties).	All objectives	Relevance {Faithful representation}
Issues with classification		
Certain non-cash transactions related to multiple-component transactions should be included in the statement of cash flows.	All objectives	Relevance {Faithful representation}
The classification in the statement of cash flows should not depend on whether or not the expenditure would be capitalised in the statement of financial position.	Objectives: 5 (1a; 4; 6a)	Relevance
	Objectives: (1a; 1b.1; 4; 6a)	{Relevance}
Inflows and outflows should be classified consistently.	Objectives: 1b.2; 4; 6a	Relevance
	Objectives: 2; 3; 4; 6b	{Relevance}

Issue	Particular relevant for	Qualitative characteristics mainly affected {potentially adversely affected by a solution}
There should be a distinction between operating and finance lease.	Objective 4	Relevance
	Objectives: 2; 6b;	{Relevance}
Tax payments should not be classified as operating cash flows 'by default'.	Objectives: 1b.2; 4; 6a	Relevance
Tax payments should be presented separately, like in IFRS 18.	Objectives: 1b.2; 4; 6a	Relevance
Insufficient disclosures		
Better disclosures on the preparation and classification choices made by the entity.	All objectives	Relevance; faithful representation
Better disclosures about intercompany cash flows.	Objective: 1a	Relevance
Better information on restrictions and location of cash.	Objectives: 2; 3; 4;6b	Relevance; faithful representation
Better information on liquidity and ability to service debt.	Objectives: 2; 3; 4; 6b	Relevance
Better information on non-cash income.	Objectives: 1a; 1b.2; 4; 6a	Relevance
Better information about non-recurring cash flows.	Objective: 4	Relevance
Better information about the impact of business combinations.	Objectives: 1b.2; 4; 6a	Relevance
Reconciliations.	All objectives	Understandability
Need for more disaggregated information		
Minimum requirements for disaggregation of information.	All objectives	Relevance; understandability, faithful representation
Distinguishing between expenditures used for maintenance and growth.	Objective: 4	Relevance; {faithful representation}
Distinguish dividends to controlling and non-controlling interests.	Objective: 4	Relevance

Objective 1a: understand the business; **Objective 1b.1**: assess closeness to cash; **Objective 1b.2**: assess current performance; **Objective 2**: assess the financial structure; **Objective 2a:** assess an entity's liquidity **Objective 2b:** assess an entity's solvency; **Objective 3**: assess agility; **Objective 5:** Assessing the effects of different accrual accounting practices **Objective 6a**: assess management's general performance; **Objective 6b:** assess management's cash management.

Issues with included/excluded transactions

4.6 The statement of cash flows prepared under IAS 7 shows changes in cash and cash equivalents as defined in the Standard (see below). There are six issues related to this:

a) The requirements on what should be considered cash and cash equivalents are interpreted differently and may accordingly not result in comparable information;

b) The requirements on what should be considered cash and cash equivalents do not result in the most relevant information for all objectives of the statement of cash flows;

c) Uncertainty on how to deal with agent/principal like transactions;

d) Exclusion of certain non-cash transactions does not result in comparable information;

e) Exclusion of all non-cash transactions does not in the most relevant information for all objectives;

f) There is divergence in practice on when to include certain cash flows in the statement of cash flows.

Different interpretations on what are cash and cash equivalents

4.7 According to Chapter 2, some of the objectives of the statement of cash flows are to:

a) assess an entity's cash management practices (Objective 6b);

b) assess an entity's liquidity (Objective 2a);

c) assess an entity's solvency (Objective 2b);

d) assess an entity's agility (Objective 3);

e) assess the ability of the entity to generate cash and cash equivalents (Objective 4);

f) Assessing the effects of different accrual accounting practices (Objective 5).

4.8 Particularly for objectives: 2a, 2b, 5 and 6b, it can be important what is considered cash and cash equivalents (for Objective 4, the importance depends on how the statement of cash flows is used). For example, the conclusion impacts liquidity ratios and could also impact compliance with regulatory requirements[51].

4.9 The definitions of cash and cash equivalents are therefore important for presenting the changes in cash and cash equivalents in the statement of cash flows, particularly to ensure relevant and comparable information related to the objectives mentioned above.

4.10 Paragraph 6 of IAS 7 provides the definitions of cash and cash equivalents:

Cash comprises cash on hand and demand deposits.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

4.11 Under the heading 'cash and cash equivalents', paragraph 7 of IAS 7 further states that:

[51] Information collected at EFRAG round tables on the statement of cash flows

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or 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 qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date.

4.12 There can be different interpretations on the definitions of cash and cash equivalents, which may cause diversity in practice on what can be classified as cash and cash equivalents[52].

4.13 As it appears from the definition, cash comprises cash at hand and demand deposits. Even though IAS 7 does not provide a definition of 'demand deposits', these are considered to be commonly understood in practice. Also, the amounts not classified as 'cash' because they do not qualify as 'demand deposits', may still qualify as 'cash equivalents'[53]. Respondents to the IASB's third agenda consultation supported the review of the definition[54].

4.14 However, there are several issues with what is considered cash and cash equivalents which could affect the comparability between entities of the information provided for the objectives mentioned above. These include:

a) Whether cash in transit falls within the definition of cash[55].

b) What the meaning is of 'short-term maturity'. Here the main issue is whether the reference to 'three months' in paragraph 7 of IAS 7 should be strictly interpreted or being considered as a benchmark/example[56]. This results in diversity in practice on how entities apply the notion of short-term maturity. Although some consider the requirements to be unclear, EFRAG has also heard the view that the requirements are sufficiently clear but are not applied by preparers (and auditors)[57].

c) Whether digital currencies meet the definition of 'cash and cash equivalents'. Literature discusses two types of digital currencies: central bank digital currencies (CBDCs) and privately issued cryptocurrencies (e.g., Bitcoin)[58]. This section only deals CBDCs, as privately issued cryptocurrencies do not classify as cash according to the IFRIC agenda decision issued in 2019[59]. In contrast, CBDC is considered by some to be 'cash', as it is the digital form of a country's currency issued by a central bank[60] intended to act as an equivalent to cash[61]. However, there are arguments against classifying CBDC as cash, as there could be both positive and negative interest charges

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[52] EY International Financial Reporting Group. 2024.

[53] EY International Financial Reporting Group. 2024.

[54] IASB (2022).

[55] Information collected at EFRAG round tables on the statement of cash flows

[56] Information collected at EFRAG round tables on the statement of cash flows

[57] Information collected at EFRAG round tables on the statement of cash flows

[58] Alsalmi et al. 2023.

[59] IFRIC. 2019.

[60] EY International Financial Reporting Group. 2024.

[61] Alsalmi et al. 2023.

on CBDC. This causes diversity on how digital currencies are dealt with across jurisdictions[62].

d) How and entity (and its auditors) assess whether there is an insignificant risk of changes in value. As the default position seems to be that an item is not cash or cash equivalent, some entities may put efforts into providing supporting evidence of the existence of only an insignificant risk of changes in value, while other entities may not find the challenges of gathering sufficient evidence to support that statement worthwhile[63], and hence choose to consider the item as non-cash.

4.15 The issues listed above could, in addition to affect the comparability between entities of the information in the statement of cash flows also result in difficulties for users in understanding what exactly is reflected in the statement of cash flows and accordingly the perceived faithful representation[64].

4.16 As a result of these issues, some suggest considering removing of cash equivalents from the statement of cash flows. It would be easier to clarify what is 'cash' than what is 'cash and cash equivalents'[65].

The requirements on what should be considered cash and cash equivalents do not result in the most useful information

4.17 Some are also questioning whether the current definitions of cash and cash equivalents result in the most useful information. However, some of the concerns expressed point in different directions.

a) Some consider the requirements to be too restrictive on what can be considered 'cash and cash equivalents'. For example, some do not find it useful that for example six months term deposits are not considered cash equivalents as these assets can be easily converted into cash and their exclusion from the statement does not align with the entity's liquidity management approach[66]. In other words, the current requirements do not result in the most useful information for assessing management's cash management (Objective 6b). Similarly, some credit rating agencies may consider a longer conversion period (of, for example, six months) when assessing credit ratings (Objective 2b).

b) Others consider that the requirements are not sufficiently restrictive. The requirements allow investments for which time is needed for cash conversion to be considered 'cash equivalents' and hence appear from the statement of cash flows. This seems to be the case even if the time needed is several months. Therefore, from a liquidity perspective they may not be readily available in reality[67]. In other words, the current requirements do not result in the most useful information for assessing liquidity (Objective 2a).

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[62] Information collected at EFRAG round tables on the statement of cash flows.

[63] Information collected at EFRAG round tables on the statement of cash flows.

[64] The Footnotes Analyst. 2024.

[65] Information collected at EFRAG round tables on the statement of cash flows.

[66] Information collected at EFRAG round tables on the statement of cash flows.

[67] Information collected at EFRAG round tables on the statement of cash flows.

Uncertainty on how to deal with agent/principal like transactions

4.18 There are differing views on how to present cash flows when an entity is directing another party to pay and/or receive cash on its part (i.e. situations where another party acts as an agent of the entity) in a multiple component transaction which, for example, could involve both the transfer of an asset and a financing agreement. There is no broader guidance on this included in IAS 7[68]. The question here is whether cash flows should be presented as if the entity itself had paid/received the cash flows or should only include the cash flows between it and the agent. For example, if an entity purchases an asset and finances the purchase by borrowing money from a bank, it may arrange for the money to be paid directly by the bank, instead of first receiving the money and then paying it to the vendor of the asset[Error! Bookmark not defined.].

4.19 Similarly, it is unclear whether VAT cash flows should be included in the statement of cash flows. Due to the absence of explicit guidance, entities may adopt different practices for reporting VAT cash flows, potentially affecting the comparability of financial statements[69].

Exclusion of all non-cash transactions does not result in comparable information

4.20 In this DP, non-cash transactions are considered to be:

a) Transactions that do not involve cash or cash equivalents. For example, the purchase of an asset by means of own shares, sales for which bitcoins are received or converting debt to equity.

b) Multiple components transactions that involve cash or cash equivalents, but which result in the cash flows to and from an entity being reduced compared to a situation where the various components had not been bundled. For example, acquiring an asset by assuming a directly related liability (including obtaining a right-of-use asset in exchange for a leases liability); and reverse factoring arrangements (which resembles cash transactions involving credit facilities)[70].

4.21 Multiple component transactions may not only affect the cash flows of a transaction but could alternatively/also affect the classification of the cash flows (see below on categorisation issues).

4.22 Some argue that excluding all non-cash transactions from that statement of cash flows does not result in comparable information. For example, some argue that 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 purchase an asset with the cash received. They accordingly argue that the two transactions should be presented similarly in the statement of cash flows. The same could apply to other non-cash transactions, including sales in exchange for cryptocurrencies; the acquisition of assets either by assuming directly related liabilities or by means of a lease; obtaining a building or investment asset by receiving a gift; obtaining a beneficial interest as consideration for transferring financial assets (excluding cash); and the conversion of debt to equity[71].

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68 EY (2024).

69 Badenhorst & Ferreira (2016).

70 Information collected at EFRAG round tables on the statement of cash flows.

71 IAS 7.44 and ACS 230-10-50-4.

Exclusion of all non-cash transactions does not result in the most relevant information for all objectives of the statement of cash flows

4.23 In addition to not resulting in comparable information, some argue that excluding all non-cash transactions from the statement of cash flows does not result in the most relevant information. Some financial statements users disagree that the statement of cash flows should focus only on cash, as in practice non-cash transactions[72] are considered in their analyses[73].

4.24 Not including certain non-cash transactions such as the acquisition of an asset by means of own shares could impede the relevance of the statement of cash flows for: understanding the entity's business (Objective 1a); assessing the management's general performance (Objective 6a). However, including such transactions could impede: assessing the cash management (Objective 6b); assessing the quality of earnings (Objective 1b.1); assessing the entity's financial structure (Objective 2); and assessing the entity's ability to affect the amounts and timing of cash flows (Objective 3).

4.25 For the purpose of assessing the ability of the entity to generate cash and cash equivalents (Objective 4) and comparing entities (Objective 5), including non-cash transactions could have both benefits and disadvantages for the relevance of the information provided in the statement of cash flows. For the purpose of assessing the ability of the entity to generate cash and cash equivalents, it could, for example, be beneficial for those who use the information on capital expenditures that this figure would include acquisition made by transferring own shares. On the other hand, if the entity's possibilities of paying dividends is in focus, including revenue received in non-cash (and cash equivalent items) may reduce the usefulness of the statement. For the purpose of comparing entities, it could, on the one hand be beneficial to include similarly transactions that have the same economic effect (see the example in paragraph 4.22 above). On the other hand, when non-cash items are received or used for payment, valuation of these items may be needed, and this could impede the independence of measurement requirements/guidance of the statement of cash flows.

4.26 Not including all cash flows in multiple component transactions when the third party acts an agent for the entity could impede the relevance of the information in relation to all of the objectives.

4.27 However, reflecting both types of non-cash transactions discussed in this DP (see paragraph 4.20) in a statement of cash flows could also be argued not to be a faithful representation.

Issues with classification

4.28 As per paragraph 10 of IAS 7, an entity needs to classify cash flows by operating, investing, and financing activities.

4.29 This DP discusses two issues related to the requirements in IAS 7 on classification:

a) There is diversity in practice in relation to how some cash flows are classified which result in information that is not comparable between entities.

[72] Information collected at EFRAG round tables on the statement of cash flows.

[73] Information collected at EFRAG round tables on the statement of cash flows.

b) The requirements in IAS 8 on classification do not always result in the most relevant information.

Transactions are not classified in a comparable manner

4.30 Munter (2023) notes that when the staff of the Office of the Chief Accountant of the U.S. SEC has not found analyses persuasive concluding that an error in the statement of cash flows is not material because it is an error in classification only. Munter (2023) notes that classification itself is the foundation of the statement of cash flows. Accurately classifying cash flows as operating, investing, or financing activities is paramount understanding the nature of the issuer's activities that generated and used cash during the reporting period.

4.31 Even though IFRS 18 has made some minor amendments to IAS 7, and in particular relevant to this chapter, the presentation of interest and dividends paid and received[74] addressing some classification issues, many others still persist.

4.32 IAS 7 provides broad definitions of the categories and a non-exhaustive list of examples, which often result in misclassification errors and diversity on how similar transactions are presented across entities[75]. There are thus two reasons to why cash flows are classified differently between entities: 1) options included in IAS 7 on classification 2) insufficient guidance on how to classify cash flows.

Options included in IAS 7

4.33 The issuance of IFRS 18 in April 2024 also resulted in some of the explicit options provided in IAS 7 on the classification of payments or cash receipts form interest and dividends being removed. However, for entities that invest in assets or provide financing to customers as a main business activity, there is still some flexibility in relation to the categorisation of interest and dividend received and interest paid.

Cash flows for which there is no explicit guidance

4.34 After the issuance of IFRS 18 most of the divergence in practice can be expected to result from different interpretations of the requirements and/or no clear guidance on how to classify certain cash flows. The cash flows for which diversity currently exists in practice include:

a) payments related to unfunded defined benefit pension schemes[76];

b) cash received from factoring of trade receivables[77];

c) cash received from a government grant;

d) cash payments related to the purchase of an asset on deferred payment terms from the supplier[77];

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[74] PwC Viewpoint (2024).

[75] EY International Financial Reporting Group (2024).

[76] Information collected at EFRAG round tables on the statement of cash flows.

[77] EY (2024).

e) cash received in a sale and lease back arrangement where the transaction qualifies as a sale under IFRS 15;

f) cash received and cash payments related to derivatives that are 'collateralised-to market'.

g) cash payments related to supply-chain financing arrangements and reverse factoring arrangements[78] [79];

h) payment of deferred consideration in a business combination;

i) payment of variable consideration for an asset outside of a business combination[80];

j) payment during the construction phase of a service concession arrangement[81];

k) cash flows on derivatives that are economic hedges[82]

4.35 Some point to the definition of operating activities in IAS 7 as a cause of the diversity in practice[83]. Operating activities are defined as:

the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. (IAS 7.6)

4.36 The term 'operating cash flows' can thus be confusing as it may not directly relate to operating income. New, innovative transactions are difficult to classify within cash flow statements and often default to the operating category. Some thus consider that clear classification requirements for new types of transactions are needed.[84]

4.37 However, different views exist on whether operating activities should be defined directly or left as a residual category. If defined directly, it could result in excluding some classes of expenditures which are intended to enhance operating capabilities but not capitalised as assets.[85]

4.38 Input collected by EFRAG has suggested that to be most relevant for users of financial statements, the classification should be based on whether the cash flow is related to the impact of operations or is relevant for understanding leverage[86].

Classification requirements/choices do not result in the most relevant information

[78] Information collected at EFRAG round tables on the statement of cash flows.

[79] EY (2024).

[80] EY (2024).

[81] Deloitte (2024).

[82] Deloitte (2024).

[83] Information collected at EFRAG round tables on the statement of cash flows.

[84] Information collected at EFRAG round tables on the statement of cash flows.

[85] Information collected at EFRAG round tables on the statement of cash flows.

[86] Information collected at EFRAG round tables on the statement of cash flows.

4.39 Some consider that the current guidance on how to classify cash flows as well at the classifications that may in practice sometimes be applied due to the lack of clear requirements may not result in the most useful information.

Multiple component transactions

4.40 One of the issues is here related to the multiple component transactions described in paragraph 4.20b) above.

4.41 The fact that non-cash transactions are not reflected in the statement of cash flows can, for example, result in the entity having no cash outflows related to the payment of suppliers if there is a supplier finance arrangement that result in extended credit terms for the entity (the purchaser). In this case, depending on the circumstances, all payments related to goods and services acquired by an entity could be presented as financing cash flows. Similarly, if an entity, for example, is factoring its receivables and the customers are required to pay directly to the financial institutions, but the arrangement does not result in the derecognition of the original trade receivable, it could be, depending on facts and circumstances as well as the interpretation of the current requirements, that cash flows from operating activities would not include cash flows related to the sale of the entity's goods and services. Some do not consider this results in comparable and the most relevant information.

4.42 The solution to the issues above, would, however, likely not be to require the cash flows mentioned above as operating cash flows as this would not reflect the financing that is also taking place.

4.43 As cash flows from operating activities is important for most of the objectives of the statement of cash flows, the relevance of the statement of cash flows for these objectives is accordingly affected. On the other hand, reflecting non-cash transactions in the statement of cash flows could be argued to reduce the faithful representation of the statement.

Only classifying expenditures that are capitalised as cash flows from investing activities

4.44 According to IAS 7.16 (which was added in 2008), only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities.

4.45 Some do not consider this to result in the most relevant information. One concern expressed it that not presenting investments in unrecognised assets may result in operating cash flows being underestimated[87]. As noted above, relevant information on cash flows from operating activities is relevant for most of the objectives of the statement of cash flows identified in this DP. In addition, as capex information from the statement of cash flows is also an important information for the assessment of the ability of the entity to generate cash and cash equivalents, the information provided in this regard may not be the most relevant. Finally, as the classification would then depend on the accounting treatment of certain expenses (e.g. research and development expenditures) the relevance of the statement of cash flows for comparing entities (Objective 5) is reduced.

[87] Barker & Penman (2020).

4.46 On the other hand, not linking the classification to the accounting treatment in the statement of financial position could have resulted in divergence in practice on which cash flows would have been presented under investment activities (comparability would be affected). Different 'categorisation' in the statement of cash flows and the statement of financial position could also reduce the understandability of the financial statements.

Inconsistent classification of inflows and outflows

4.47 Another point raised by some as not resulting in the most relevant information is that some cash inflows can be classified as resulting from operating activities, while the related outflows are presented under another activity. Some do not consider this to result in the most relevant information about the cash flows from operating activities, which is considered for most of the objectives of the statement of cash flows stated in this DP.

4.48 This could, for example, happen in relation to supplier finance arrangements (see above) and cash received from a government grant.

Distinction between operating and finance lease

4.49 Some users of financial statements prefer the previous distinction in IFRS Accounting Standards between operating and finance lease. They note that it is confusing that cash flows that were previously related to operating leases and presented as cash flows from operating activities are now presented under financing activities[88]. They consider that for a more relevant classification, the difference between lease and in-substance purchase should be better clarified by the IASB. The classification also impacts the entity's KPIs and the presentation of related outflows in the cash flow statement.

Classification of payments of taxes

4.50 In relation to the classification of tax payments two issues have been raised to EFRAG as part of its proactive project on the statement of cash flows:

a) Firstly, that the 'default' classification of tax payments as cash flows from operating activities results in taxes. According to some this means that taxes related to, for example, financing is presented as cash flows related to operating activities.

b) Secondly, classifying even taxes related to operating activities as cash flows from operating activities creates an inconsistency with IFRS 18 since income taxes are not considered part of operating profit. Therefore, some suggest that taxes should be a separate category to allow comparison with the statement of profit or loss.

Presentation of cash flows from operating activities

4.51 IAS 7.18 requires entities to present cash flows from operating activities using either the:

> **Direct method**: major classes of gross cash receipts and gross cash payments are disclosed.
>
> **Indirect method:** profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

[88] Information collected at EFRAG round tables on the statement of cash flows.

4.52 The option to use either method creates differences in how entities present cash flows from operating activities. This is especially challenging when different methods are used within the same group, which can potentially lead to inconsistencies in reporting[89].

4.53 Some may argue that having one way of presenting cash flows from operating activities would enhance comparability, however, removing the option for entities to apply the direct or indirect could be costly and would, according to some have limited benefits[90]. Improving the disclosures including information on both direct and indirect cash flows would be another alternative and this might enhance transparency and accuracy of financial information used by analysts, and consequently reduce forecasting errors[91] .

4.54 The following sections outline the advantages and disadvantages of the direct and the indirect method.

Direct method

4.55 Under the direct method, information about major classes of gross cash receipts and gross cash payments, can be obtained from:

a) the accounting records of the entity; or

b) by adjusting sales, cost of sales and other items in the statement of comprehensive income.

Advantages

Clarity and understandability

4.56 IAS 7.19 encourages entities to apply the direct method to present income from operating activities, as it provides information useful for estimating future cash flows. Similarly, the FASB[92] and the SEC encourage issuers to consider using the direct method to enhance investors' understanding of the statement of cash flows and the overall financial statements[93].

4.57 The direct method is often considered more intuitive and easier to understand by users[94]. Moreover, US-based investors have confirmed that the indirect method is not intuitive and lacks sufficient information for their decision-making process. The additional detail provided by the direct method helps finance staff create forecasts that executives can easily understand[95].

89 Information collected at EFRAG round tables on the statement of cash flows.

90 Information collected at EFRAG round tables on the statement of cash flows.

91 Information collected at EFRAG round tables on the statement of cash flows.

92 ASC 230-10-45-25.

93 Munter (2023).

94 Information collected at EFRAG round tables on the statement of cash flows.

95 Munter (2023).

Granularity of information

4.58 Academic studies have shown that information presented using the direct method is incrementally useful beyond that provided by the indirect method and other financial statements[96]. Specifically, the direct cash flow components of cash receipts from customers was the most valuable information within the operating activities section of the direct statement of cash flows and useful in forecasting future cash flows[97].

4.59 The direct method has also been associated with lower levels of information asymmetry, compared to the indirect method, reducing the cost of obtaining information and consequently lower the cost of raising capital for entities.

4.60 Following the 2021 FASB Agenda Consultation, investors have indicated a preference for requiring the direct method, as it would improve decision-making and liquidity information (e.g., cash collected from customers that is only available using the direct method). Moreover, they emphasised that the direct method should be required because there is a greater need for transparency and detail of the operating section, and the direct method serves as a useful analysis tool[98].

Disadvantages

Complex and challenging application

4.61 Input collected by EFRAG indicates that preparers consider these challenges in using the direct method, mainly due to their complex corporate structure, different currencies, different reporting entities, multiple bank accounts across countries, and high volume of transactions. In some cases, they noted that the system in place does not provide practical support to achieve the presentation using the direct method, and it is even hard to understand to which category each payment relates to (some transactions may combine different categories)[99].

4.62 In the 2021 FASB agenda consultation, a majority of preparers, alongside trade groups and state CPA societies noted the potential complexity and associated of requiring the direct method. Companies with complex operations and structures would face increased costs associated with preparing the statement of cash flows using the direct method[100].

[96] See, for example, Hales and Orpurt (2003) and Cheng & Hollie (2008).

[97] See, for example, Nallareddy et al. (2020), Hales and Orpurt (2003) and Krishnan & Largay (2000).

[98] Munter (2023).

[99] Information collected at EFRAG round tables on the statement of cash flows.

[100] Munter (2023).

Limited usefulness of large figures that are not informative

4.63 Some preparers and users doubt that information provided under the direct method would help analysts to improve their forecasting[101]. Input collected by EFRAG has indicated that users are interested in understanding differences between operating profit and the related cash flows (e.g., Objective 1b.1). Under the indirect method large figures would attract the attention of analysts, without being informative for this purpose[102].

Indirect method

4.64 Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

a) changes during the period in inventories and operating receivables and payables;

b) non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, and undistributed profits of associates; and

c) all other items for which the cash effects are investing or financing cash flows.

Advantages

It is widely used

4.65 Although IAS 7 encourages the direct method, most entities present income from operating activities using the indirect method[103]. However, it has been observed that preferences vary across jurisdictions and organisations[104].

It provides useful information and the link with the other statements

4.66 Input collected by EFRAG from European users of financial statements, indicated that they had clear preference for the indirect method of presenting cash flows from operating activities. They considered the indirect method was helpful for forecasting growth and understanding how much cash flow is being absorbed by working capital[105].

4.67 The indirect method provides a link between the cash flow statement and the statement of financial performance, which can be used alongside users' analyses.[106]

[101] Information collected at EFRAG round tables on the statement of cash flows.

[102] Information collected at EFRAG round tables on the statement of cash flows.

[103] Hales & Orpurt (2003).

[104] Information collected at EFRAG round tables on the statement of cash flows.

[105] Information collected at EFRAG round tables on the statement of cash flows.

[106] Information collected at EFRAG round tables on the statement of cash flows.

Disadvantages

Less detailed information

4.68 A limitation of the indirect method is that that it does not show actual cash flows, turning the cash flow statement into a reconciliation of other statements[107]. This means that the information needed to calculate cash flows from operating activities using the indirect method is already available in the other financial statements, without providing any new information[108]. The direct method is more useful in some cases, such as obtaining information on supply finance arrangements[109].

Variability in application

4.69 There is significant variability in how companies and industries present cash flows using the indirect method, which makes comparability and analysis more difficult[110].

Insufficient disclosures

4.70 The disclosure requirements in IAS 7 are, when compared with other IFRS Accounting Standards, relatively limited. Input collected by EFRAG indicates that additional disclosure requirements on particularly the following issues are wanted:

a) Preparation and classification choices made by the entity[111]. Information on classification choices relates to cash flows for which the classification is not obvious, for example, payments related to defined benefit pension plans[112] and other of the classifications listed in paragraph 4.34. Also, users have observed that changes in foreign exchange rates are treated inconsistently in the cash flow statement, and it is also often unclear how foreign exchange rate changes has been dealt with in the reconciliation of operating cash flow and changes in working capital.[113]

b) Intercompany cash flows. Some preparers, for example, experience, and users confirmed[114], that more information on ‘upstreaming of cash flows‘ is wanted. For example, in a case where significant investments are made without additional cash flows from financing activities. Users wanted to know which part of a group was ‘financing’ this investment[115]. Also, users want to know where in a group the cash is held, as cash held by one company in a group may not be available for another entity in the group[116].

[107] Information collected at EFRAG round tables on the statement of cash flows.

[108] Greuning et al. (2013).

[109] Information collected at EFRAG round tables on the statement of cash flows.

[110] Munter (2023).

[111] Information collected at EFRAG round tables on the statement of cash flows.

[112] Information collected at EFRAG round tables on the statement of cash flows.

[113] Information collected at EFRAG round tables on the statement of cash flows.

[114] Information collected at EFRAG round tables on the statement of cash flows.

[115] Information collected at EFRAG round tables on the statement of cash flows.

[116] Information collected at EFRAG round tables on the statement of cash flows.

c) Restrictions on cash. This information is used for assessing cash availability[117] which is necessary for estimating future dividends, debt service and capex abilities. As cash within a group may not be (readily) available for another entity within a group, some users request additional information on an entity's ability to service debt and invest[118]. For example, entities with subsidiaries in other countries might be restricted from cash transferring by the local regulators, as they can be required sometimes to keep a certain level of liquidity locally, therefore there is a need for more disclosure[119]. If the cash of a group is 'located' at the entities that will have to service debt or should make investments, there may not be an issue, but if there are restrictions on how cash can be transferred, and the cash is not 'at the right places' problems can arise. Therefore, more disclosure is demanded on what cash is restricted and for what type of activities[120]. IAS 7.48 requires an entity to disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group. However, users notes that the manner entities currently report on cash restrictions is inconsistent[121] and they do not consider they (always) receive sufficient information on this.

d) Liquidity and ability to service debt. Some do not consider the information provided in the statement of cash flows (together with the other information presented in the financial statements) to be sufficient to assess an entity's financial structure (Objective 2). Liquidity mismatches (particularly relevant for certain sectors) that may result in actual liquidity problems are not captured by the current financial statements.[122] It has also been noted that the information on interest payments does not inform whether payments are related to service debt. They suggest additional information on liquidity and collateral is needed.[123]

e) Information about non-cash income. Some users would like to know more about the non-cash income. It is noted that sometimes the management report include more detail about this[124]. Although IAS 7 require disclosures of material non-cash transactions cases were found by the FRC that these disclosures were missing or could be improved[125].

f) Information about non-recurring cash flows. In order to assess the entity's ability to generate cash and cash equivalents (Objective 4), some users consider that information about 'one-off' or 'non-recurring' cash flows would be useful.

g) Information about the impact of business combinations. Business combinations are causing disruption to the statement of cash flows and financial analyses and the information required by IFRS 3 *Business Combinations* seem to focus on the effects on the statement of financial position and the statement of profit or loss. Therefore,

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[117] Information collected at EFRAG round tables on the statement of cash flows.

[118] Information collected at EFRAG round tables on the statement of cash flows.

[119] Information collected at EFRAG round tables on the statement of cash flows.

[120] Information collected at EFRAG round tables on the statement of cash flows.

[121] Information collected at EFRAG round tables on the statement of cash flows.

[122] Information collected at EFRAG round tables on the statement of cash flows.

[123] Information collected at EFRAG round tables on the statement of cash flows.

[124] Information collected at EFRAG round tables on the statement of cash flows.

[125] PwC (2022).

additional information is needed to understand how the statement of cash flows has been affected by business combinations. For example, information similar to the information required for revenue and profit or loss in IFRS 3 BC64(q) could be considered (information about revenue and profit or loss of the acquiree since the acquisition data and if the acquisition data had been as of the beginning of the annual reporting period).

h) Reconciliations. In relation to the IASB's Third Agenda Consultation, some respondents (including some users) commented that they have difficulty reconciling the statemen of cash flows to the other primary financial statements. Most of those respondents highlighted the need for more information about non-cash movements (see above)[126]. Similar input has been provided to EFRAG from preparers. Preparers thus experience that users of financial statements are asking them about how the information reconciles. From input collected by EFRAG, it also appears that some users struggle to understand the connections between the statement of profit or loss, statement of financial position and the statement of cash flows in relation to leases.[127] A survey conducted by the FASB in the USA showed support for a reconciliation between changes in statement of financial position line items and the corresponding changes in the statement of cash flows with strong support for reconciling revenue-related accounts (such as account receivables, contract assets, and contract liabilities)[128]. Also, Munter (2023), for statement of cash flows prepared in the USA, called for preparers to consider disclosing a reconciliation between changes in the statement of financial position items and the corresponding changes in the statement of cash flows.

4.71 In addition to these additional disclosures, there is also a request for further disaggregated information. This information is considered in the next section. Further disaggregated information can either be presented on the face of the statement of cash flows or in the notes.

Need for more disaggregated information

4.72 Input collected by EFRAG indicates that some users find the degree of detail in the statement of cash flows of many entities insufficient. This makes it difficult to understand the sources and uses of cash. IAS 7 allows too much flexibility on how to aggregate information in very different categories, meaning that entities can avoid disclosing really important information[129].

[126] IASB agenda paper 24E for the March 2022 IASB meeting.

[127] Information collected at EFRAG round tables on the statement of cash flows.

[128] FASB (2023b).

[129] ACCA (2020).

4.73 Similar information has been found in the USA. Munter (2023) thus called for preparers to consider to further disaggregate amounts reported in the statement of cash flows. In response to the 2021 FASB agenda consultation, investors and other financial statement users generally agreed that greater disaggregation of financial information in the statement of cash flows, or in the notes to the statement of cash flows, should be a top priority for the FASB to help them better perform their analyses (FASB 2021b). Respondents to the agenda consultation were, in relation to the statement of cash flows seeking information to understand: global tax risk (by providing information on the amount of cash taxes paid by jurisdiction or geographical segment and disaggregation of the types of taxes paid, such as the global intangible low-taxed income tax and the base erosion and anti-abuse tax), effects of business combinations to compare a company pre/ and post- acquisition, effects of environmental, social, and governance matters on financial statement line items, effects of foreign currencies on financial statement line items, cash flows of partially owned subsidiaries and equity method investments (investors would like to better understand cash flows from operations generated by these entities), cash flows attributable to non-controlling interests. In the FASB Investor Survey in 2022, showed that 'cash received from customers' received the most support and was the highest priority disclosure (FASB 2023b). One credit rating agency requested that the FASB consider requiring entities to separately disaggregate the types of cash interest paid by debt refinancing, financing fees, and non-debt-related interest. This disclosure would assist investors in calculating certain metrics such as funds from operations.

4.74 The input received by EFRAG has primarily focused on more disaggregated information in relation to:

a) The items whereby (operating) profit or loss is adjusted under the indirect method of presenting cash flows from operating activities. Particularly in relation to 'non-cash add-back items'[130]. The level of details provided in the statement of cash flows currently differs significantly from entity to entity.

b) Capital expenditures used for maintenance (maintenance capex) versus capital expenditures for growing a business (growth/investment capex) [131]. This distinction is, for example, important when calculating free cash flows and is thus related to the relevance of the information provided in relation to Objective 4. IAS 7 already encourage entities to disclose the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity. In addition to preparers, some users[132] of financial statements consider that it would be very difficult for entities to make such a distinction and resulting information could provide useful information. For preparers to provide the information, clear definitions of the different types of capex would be needed[133]. Others have suggested capex being broken further down into more items, to make it further help users making their own assessments on maintenance versus investment capex[134]. In addition to distinguishing between maintenance and growth capex, some also suggests considering 'not going out of business capex'.

[130] FASB (2021).

[131] Information collected at EFRAG round tables on the statement of cash flows.

[132] Information collected at EFRAG round tables on the statement of cash flows.

[133] Information collected at EFRAG round tables on the statement of cash flows.

[134] Information collected at EFRAG round tables on the statement of cash flows.

c) Dividends to controlling versus non-controlling interest. IAS 7 does not distinguish between dividends to non-controlling interests and to common shareholders, some users have suggested that these should be presented separately in two-line items[135]. This information would, for example, be relevant for users estimating the value of the parent entity's equity by considering dividend payments (Objective 4). Respondents to the FASB agenda consultation have presented similar views[136].

4.75 Non-controlling interest is not sufficiently disaggregated, leading to a lack of clarity. Munter (2023) Respondents to the agenda consultation were, in relation to the statement of cash flows seeking information to understand cash flows attributable to non-controlling interests.

Definitions

4.76 IAS 7 only provides the definition of cash and cash equivalents, for which related issues have been discussed above. Input received from EFRAG suggested that the lack of definition for key components of the cash flow statement may create the following issues[137]:

a) Inconsistencies on how entities interpret the requirements;

b) Inconsistent level of detail on how entities report these items;

c) Items that do not represent cash flows end up being included in the statement of cash flows;

d) The cash flow statement ends up being the reconciliation of the statement of profit or loss and the statement of financial position.

4.77 Based on the input received, the following items that are not defined and are widely used by users have been highlighted:

a) Working Capital;

b) Maintenance vs. growth Capital Expenditure (CAPEX);

c) Net Debt;

d) Free Cash Flow (FCF).

[135] Information collected at EFRAG round tables on the statement of cash flows.

[136] Munter (2023).

[137] Information collected at EFRAG round tables on the statement of cash flows.

Lack of Definition of working capital and changes in Working Capital:

4.78 Input received from EFRAG highlighted the need for definitions and disclosures of working capital items to enhance understanding and comparability[138]. Investors frequently inquire about the components of reported working capital, specifically focusing on liabilities, prepayments from customers, future cash flows. In contrast, another view was that there is no need for a definition, as long as entities provide disclosures on what they believe working capital items are and what are the changes.[139]

4.79 Respondents to the FASB agenda consultation have similarly observed that, although questions on cash flow information are limited, there have been past requested about the key drivers of variability across periods, such as accounts receivable fluctuations, working capital changes, and nonrecurring items[140].

4.80 The 2021 FASB agenda consultation asked preparers what requests or questions, if any, their company received from analysts on cash flow information. A few preparers provided feedback on what cash flow information requests their company receives from analysts. Three preparers stated that additional details requested by analysts are minimal and that the frequency of those inquiries is relatively low. Of the inquiries that were received, one preparer explained that past requests related to key drivers of variability across periods, such as accounts receivable fluctuations, working capital changes, and nonrecurring items. Another preparer noted that it has received questions on the clarification of the nature and definition of certain cash flows or noncash flow activities, the purchase and sale of certain assets, and intended use of cash by management. Separately, two trade groups stated that it is relatively rare for their members to receive inquiries or requests related to additional information on the statement of cash flows. (FASB 2021b)

Lack of definition of Maintenance vs. Growth CAPEX

4.81 Input from EFRAG indicated that the absence of a clear definition of assets complicates the distinction between maintenance and investment CAPEX[141].

Lack of definition of Net Debt

4.82 Although net debt is not defined, it is commonly used by users and preparers, meaning that there are different definitions and non-comparability[142]. It is considered a key performance metric that is completely 'ignored', even with the IAS 7 Disclosure initiative aimed at enhancing information related to changes in debt. The amendments to IAS 7 require disclosure of information to help users evaluate changes in liabilities arising from financing activities, however, the information provided is still insufficient [143]. Notably, the IASB acknowledged that providing a commonly agreed definition of debt would be difficult[144].

[138] Information collected at EFRAG round tables on the statement of cash flows.

[139] Information collected at EFRAG round tables on the statement of cash flows.

[140] FASB. 2021

[141] Information collected at EFRAG round tables on the statement of cash flows.

[143] ACCA (2020).

[144] Paragraph BC11 of the Basis for Conclusion on IAS 7.

Lack of Definition of Free Cash Flows

4.83 As outlined in Chapter 2 and 3, free cash flow is a metric used for understanding the business (Objective 1a) and assessing company's ability to generate cash (Objective 4). For valuation purposes, analysts use free cash flow (FCF) to estimate enterprise value and forecast financial performance[145]. This is further confirmed by respondents to the 2021 FASB Agenda Consultation, who identified free cash flows as a financial KPI commonly used across many industries[146].

4.84 All these statements confirm that free cash flow metric widely reported and used for different purposes, and the lack of a standardised definition may lead to inconsistencies on how it is calculated by analysts and reported by entities.

Cohesiveness with the other two Primary Financial Statements

4.85 Chapter 3 highlighted the benefits of using the statement of cash flows in conjunction with the rest of the financial statements. The input collected by EFRAG has revealed that using the statement of cash flows together with the other financial statements provides a holistic view on the company's performance[147] and enables the reconciliation between the financial statements[148].

4.86 Although IFRS 18 brought changes to the structure of the statement of profit or loss, containing operating, investing, financing categories, there is no alignment to those in IAS 7 as they have different meanings[149]. Therefore, income and expenses and the associated cash flows may be classified across different categories, resulting in three main issues:

a) It may be challenging to directly compare line items in the statement of profit or loss and the statement of cash flows[150]

b) It may be difficult to reconcile cash flows with other items in the financial statements[151].

c) Using the same labelling for categories under IFRS 18 and IAS 7, despite the lack of reciprocity between the two financial statements, may lead to confusion[152].

4.87 Input collected by EFRAG has also, for example, indicated that some users prefer acquisitions of PPE to be reflected as investing activities in the statement of cash flows, while the corresponding 'depreciations' would be classified in the operating category in the statement of profit or loss. As a complete alignment may therefore not seem desirable, it could be considered to amend the categories in IFRS 18 and IAS 7 so that they would not carry similar names, but have different content.

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[145] Information collected at EFRAG round tables on the statement of cash flows.

[146] FASB (2021).

[147] Information collected at EFRAG round tables on the statement of cash flows.

[148] Information collected at EFRAG round tables on the statement of cash flows.

[149] Deloitte (2024).

[150] Information collected at EFRAG round tables on the statement of cash flows.

[151] Information collected at EFRAG round tables on the statement of cash flows.

[152] Information collected at EFRAG meetings.

4.88 The input collected by EFRAG highlighted another issue concerning the cohesiveness between the statement of cash flows and the statement of financial position. Specifically, the treatment of transactions in the statement of financial position can influence the classification of the related cash flows. For instance, payments for supplier finance transactions are classified under the financing category in the statement of cash flows simply because the trade payable is treated as debt in the statement of financial position. This classification may not accurately represent the nature of the transaction according to some[153].

[153] Information collected at EFRAG round tables on the statement of cash flows.

CHAPTER 5: ALTERNATIVES TO THE STATEMENT OF CASH FLOWS

This Chapter discusses alternative approaches to the statement of cash as prepared in accordance with IAS 7 for non-financial entities. The issues with the statement of cash flows for non-financial entities were addressed in Chapter 4. This Chapter builds on the discussion by examining the alternative of a net debt reconciliation.

5.1 The statement of cash flow, despite its importance, is subject to its limitations. Chapter 5 described the issues with the statement of cash flows as currently prepared, which could be addressed following targeted improvements or a comprehensive review of IAS 7. Chapter 7 discusses further this topic.

5.2 The objective of this chapter is to discuss different approaches that could be alternative to the statement of cash flows, as required by IAS 7.

5.3 Chapter 3 highlighted that investors often reconstruct the statement of cash flows and use their own methods in estimating cash flows (Objective 4

5.4 The usefulness of a net debt statement was confirmed by some respondents (mostly users) to the IASB's third agenda consultation, who suggested the IASB to require entities to present a statement of changes in net debt, as it provides useful information for estimating an entity's enterprise value[154]. Therefore, these reconciliations serve a similar purpose and could serve as alternatives to the statement of cash flows.

5.5 A net debt reconciliation provides the reconciliation of each component of net debt. The best practices highlight key movements and show cash and non-cash drivers of changes to net debt:

a) Cash drivers: Investors are able to reconcile items in the financial statements with the relating changes in net debt[155]. It is noted that showing separately unusual cash items is very important.

b) Non-cash drivers: Investors highlight reconciling items that are non-cash movements in net debt and are typically useful to be shown separately: finance lease additions, foreign exchange and fair value movements, acquired debt and disposals.

5.6 Example disclosures are provided in the Financial Reporting Lab project report on Net Debt Reconciliations.

5.7 While the amount of cash can easily be affected just before the balance sheet by borrowing money, the net debt will not be affected by such actions.

[154] IASB. (2022).

[155] Financial Reporting Lab. (2012).

CHAPTER 6: THE STATEMENT OF CASH FLOWS FROM FINANCIAL INSTITUTIONS

This Chapter discusses whether the objectives and usages of the statement of cash flows differ between financial and non-financial entities. Chapters 2 and 3 deals with objectives and usages of non-financial entities respectively. Evidence from input collect by EFRAG and academic literature suggests that the statement of cash flows is of limited relevance for financial entities. This Chapter deals with banks and insurance companies separately, where relevant, recognising the distinct characteristics of each industry. Then, it identifies the issues with the statement of cash flows as prepared in accordance with IAS 7 specific to financial entities. Finally, alternative reporting requirements that could replace the statement of cash flows are provided.

Objectives/purpose of the statement of cash flows from financial entities

6.1 Neither the Conceptual Framework nor IAS 7 distinguish the benefits of the information provided in the statement of cash flows between financial and non-financial entities. It is considered that financial entities, like non-financial entities need cash for the same reasons.

> Users of an entity's financial statements are interested in how the entity generates and uses cash and cash equivalents. This is the case regardless of the nature of the entity's activities and irrespective of whether cash can be viewed as the product of the entity, as may be the case with a financial institution. Entities need cash for essentially the same reasons however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors. (IAS 7, paragraph 3)

6.2 Accordingly, IAS 7 requires all entities to present a statement of cash flows and provides no exemption for financial entities.

6.3 As the Conceptual Framework and IAS 7 do not distinguish between statements of cash flows prepared for financial and non-financial entities, it also follows that the deduced objectives listed in Chapter 2 above, are also intended to apply to financial institutions.

Usages of the statement of cash flows from financial entities

6.4 Chapter 2 illustrates the intended objectives of the statement of cash flows for non-financial entities. However, the input collected from EFRAG suggests that many consider the statement of cash flows for financial entities to be of limited or no relevance due to the particular business model of these entities[156]. Although the above statement is relevant for all financial entities (banks and insurance companies), the business model of insurance companies is different to that of banks[157]. Therefore, for the purposes of this discussion, there would be a distinction banks and insurance companies to reflect the specific aspects of each industry. Leasing companies are considered to be subject to some of the same issues[158].

[156] Information collected at EFRAG round tables on the statement of cash flows.

[157] EFRAG (2015).

[158] EFRAG (2016).

6.5 As indicated by the responses to EFRAG's Discussion Paper *The Statement of Cash Flows: Issues for Financial Institutions*, the relevance of the statement of cash flows of banks and insurance companies is questionable. Some thus consider that the statement does not provide relevant information for the performance and liquidity of these entities.

6.6 Although some users do not use the statement of cash flows of financial institutions (particularly not the statement of cash flows from banks), there are also users who use the information.

6.7 About half of the respondents to a FASB 2022 Investor Survey who follow financial institutions replied that they use the statement of cash flows in their analysis. Some investors would support the FASB exploring ways to make the cash flow statement more informative for financial institutions. A majority supported a 'cash interest received' disclosure.[159]

Issues for financial entities

6.8 Some of the reasons why the relevance of the statement of cash flows for financial institutions is questioned and some of the issue with the statement of cash flows for financial institutions are:

a) the business model of financial entities;

b) limited information on liquidity and solvency in the statement of cash flows;

c) insufficient disclosures accompanying the statement of cash flows;

d) the classification into operating, investing and financing categories is not useful; and

e) the direct method does not provide relevant information.

The business model of financial entities is different

6.9 The business model of non-financial entities involves converting non-cash inputs into cash, and therefore users use the statement of cash flows to assess the ability of the entity to generate cash (Objective 4).

6.10 However, this cash conversion feature is different for financial entities. For both banks and insurance companies, the objective is to match the maturity of assets and liabilities. However, there are also some differences between banks' and insurance companies' business model[160]. Due to these differences, some users do not use the statement of cash flows for banks, but use the statement of cash flows for insurance companies to understand the dividend payout capacity[161].

[159] FASB 2023b.

[160] EFRAG (2015).

[161] Information collected at EFRAG round tables on the statement of cash flows.

Banks

6.11 For banks, the main characteristic is the ability to manage the transformation of deposits into longer term credits to customers, and not to 'purchase input to generate output'. Therefore, cash flows are not linked to value creation, since these are settled through the accounts of customers[162].

6.12 Due to the unique business model of banks, some users do not use cash flow statement 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. In addition, it not used internally for risk management purposes.

Insurance companies

6.13 Unlike banks, insurance companies do not hold funds on behalf of clients and cannot create credit for their clients, their business model is rather liability-driven. Cash is collected up-front from customers, and therefore their growth is not related to external funding. The life cycle of their business is also long-term (longer than the normal reporting period of a year reflected in the statement of cash flows of annual accounts)[163].

6.14 For this reason, some users consider that the cash flow statement for insurers could be eliminated. Preparers note that if it is kept, it is preferred that requirements are kept unchanged so that there is no additional cost burden for them. As they argued that the cash flow statement is prepared because it is required and not because it is useful.[164]

Limited information on liquidity and solvency

6.15 The input collected by EFRAG suggested that the statement of cash flow fails to provide sufficient information on liquidity and solvency for financial entities, suggesting its irrelevance for these types of entities. As highlighted in the section above, the business model between banks and insurance companies differs, and therefore liquidity information is considered by users more relevant for banks, and solvency information for insurance companies.

6.16 Users often consider that the statement of cash flows provide limited information about a bank's liquidity risk exposure. Hence, one of the main issue highlighted by users is the irrelevance 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[165].

6.17 Input received from EFRAG suggested that the cash flow statement does not provide helpful information for analysing the liquidity position and dividends payout, and does not link to any KPIs or key regulatory parameters[166].

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[162] EFRAG (2015).

[163] EFRAG (2015).

[164] EFRAG (2015).

[165] EFRAG (2015).

[166] Information collected at EFRAG round tables on the statement of cash flows.

The classification into operating, investing and financing categories is not useful

6.18 It is often considered that the classification of activities into operating, investing and financing categories is irrelevant for financial institutions[167], as it does not capture important aspects of financial entities' business models[168]:

a) Assets and liabilities are largely fungible and largely interrelated to balance sheet items[169];

b) The core operations involve financing and investing activities, where the operative product is cash[170];

c) There are various maturity periods of cash flows making the classification across the three categories ineffective (for banks)[171];

The direct method does not provide relevant information

6.19 Financial entities argue that especially for them, the direct method for cash flow reporting is not useful, as it does not provide relevant information about changes in net assets, financial structure (liquidity and solvency), or the ability to influence cash flow timings[172]. For example, banks handle a high volume of daily cash transactions controlled by customers, who determine the amount and timing of payments and receipts, not the banks themselves. Therefore, it may be implied that the direct method involves significant costs, without sufficient benefits[173].

6.20 Some of the reasons why the direct method is not relevant in the case of financial entities, highlighted by respondents to the 2008 IASB's DP *Preliminary views on Financial Statement Presentation*, include:

a) The direct method does not provide superior information or align better with cohesiveness and disaggregation objectives[174];

b) The direct method fails to meet the cohesiveness objective due to the weak relationship between operating assets and liabilities and operating income and expenses[175];

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167 DRSC (2016).

168 EFRAG (2015).

169 EFRAG (2015).

170 Torfason (2014).

171 Torfason (2014).

172 EFRAG (2015).

173 Morgan Stanley (2008).

174 U.S. BankCorp. (2008).

175 Deutsche Bank (2008).

c) The direct method is particularly difficult to produce and lacks cost-benefit advantages. Indirect cash flow statements, despite their limitations, are more suitable for financial institutions[176].

Alternatives to the statement of cash flow for financial entities

6.21 As noted above, many consider that the statement of cash flows is not (particularly) relevant for financial entities. There would be practical issues involved with not requiring financial institutions to prepare a statement of cash flows. These issues include how conglomerates performing both financial and non-financial activities should present a statement of cash flows. Nevertheless, input received by EFRAG suggests that alternatives to the statement of cash flows could be considered for financial institutions.

6.22 The first alternative would be not to introduce other requirements if financial institutions would not be required to prepare statements of cash flows. Users of financial statements frequently turn to other disclosures to obtain more detailed and relevant information. For example, IFRS 7 provides information on the maturity of financial liabilities, which is not provided under IAS 7. Regulatory reporting for banks (e.g., the Basel Framework) and insurers (e.g., Solvency II) also provide relevant information on liquidity, solvency, dividend payout capacity, risks[177]. This implies that users can still retrieve necessary information, even if the statement of cash flows is abolished for financial entities.

6.23 Another approach would be to develop alternatives to replace the statement of cash flows for financial entities. Such alternatives could be to provide:

a) regulatory ratios (for banks);

b) information about dividend payout capacity (for banks);

c) a flow of regulatory capital (for banks);

d) a standardised table with stress-testing scenarios (for banks and insurers).

Regulatory ratios (for banks)

6.24 An alternative to the statement of cash flows could be a requirement for banks to provide regulatory ratios as found in the risk management reports of large banks, and all banks in the EU[178]. For example, Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), are part of the Basel III agreements and provide information on the short-term resilience of the liquidity risk profile by banks, and the funding risk respectively[179].

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176 BNP Paribas (2008).

177 Information collected at EFRAG round tables on the statement of cash flows.

178 Information collected at EFRAG round tables on the statement of cash flows.

179 BBVA (2024).

Dividend payout capacity (for banks)

6.25 Considering that the statement of cash flows does not effectively provide information on dividend payout capacity of banks, an alternative approach would be to provide detailed disclosures that focus on current regulatory capital and future expectations. Such disclosures would provide information on current regulatory capital levels, anticipated capital requirements and projections of future earnings. This approach acknowledges that liquidity is not a pressing issue for banks, as long as there is access to financing[180].

6.26 For insurance companies, however, this alternative approach may be less relevant. Insurance companies generally have predictable and sufficient cash inflows from premiums and investments to pay dividends[181].

Flow of regulatory capital (for banks)

6.27 An exercise that analysts perform is preparing a statement illustrating the flow of regulatory capital. This statement is often considered to be more beneficial than a statement of cash flows because it provides a deeper understanding of the bank's capital adequacy and financial health. By tracking the movement of regulatory capital, analysts can assess whether the equity is growing at a pace sufficient to support the growth in the loan portfolio. Moreover, this alternative could reveal potential constraints on the bank's ability to expand its lending operations to ensure compliance with regulatory requirements[182].

Provide a standardised table with stress-testing scenarios (for banks and insurers)

6.28 For both banks and insurance companies, an alternative to the cash flow statement could involve providing a standardised table with stress-testing scenarios, for example reflecting interest rate shifts. This approach could provide comparable information on how interest rate movements impact liquidity[183]. However, it should be noted that relevant disclosures on liquidity are already provided under IFRS 7 and IFRS 17, and these should be considered before developing alternative reporting requirements[184].

6.29 For banks, it could be useful to simulate a scenario, where all customers withdraw all their funds known as a 'bank run scenario'[185]. By modelling this extreme situation, users can gain an insight into a bank's liquidity resilience[186]. Past events, such as the failure of Silicon Valley Bank, illustrate the consequences arising from massive withdrawals, which lead to a bank's failure. Therefore, this alternative could be a tool for providing users with insights into a bank's liquidity management[187].

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[180] Information collected at EFRAG round tables on the statement of cash flows.

[181] Information collected at EFRAG round tables on the statement of cash flows.

[182] Information collected at EFRAG round tables on the statement of cash flows.

[183] Information collected at EFRAG round tables on the statement of cash flows.

[184] Information collected at EFRAG round tables on the statement of cash flows.

[185] Warr (2023).

[186] Information collected at EFRAG round tables on the statement of cash flows.

[187] Information collected at EFRAG round tables on the statement of cash flows.

CHAPTER 7: TARGETED IMPROVEMENTS OR A COMPREHENSIVE REVIEW?

Many of the issues listed in Chapter 4 could be addressed by targeted improvements. It could thus be expected that some of the current issues could be addressed within a relatively short time horizon. Targeted improvements may, however, not solve more fundamental issues, and the question therefore arises whether fixing some issues or comprehensively reconsider the statement of cash flows (or something instead of a statement of cash flows) should be the way forward.

7.1 Chapter 4 listed the issues with the statement of cash flows that have currently been identified by EFRAG. In addition to these issues are the questions on whether a statement of cash flows should also be required by banks and insurance companies and whether generally, the statement of cash flows should be replaced by another statement.

7.2 Should the IASB, as part of its project on the statement of cash flows, decide not to replace the statement of cash flows, it would be possible to address many of the issues listed in Chapter 4 by targeted improvements. On some issues, such as the inclusion of non-cash transactions, targeted improvements may be more difficult and could likely involve considering what the purpose of the statement should be, which in turn, could result in a comprehensive revision of IAS 7. Even if the IASB would only amend IAS 7 to address some of the issues that could be dealt with by targeted improvements, a comprehensive review of the Standard could be beneficial to ensure consistency across the various requirements.

7.3 A comprehensive review would, however, likely take many years to complete and it could therefore be questioned whether targeted amendments that could result in some benefits in the short term would be preferable compared to having a potential better standard in many years. If so, the next question would be which issues it would be most important to solve. Differing views may exist on this, and some might therefore consider that any potential targeted improvements would not help much.

7.4 An alternative to either making targeted improvements or performing a comprehensive review would be to do both under a phased approach. Under such an approach, issues that could be addressed easily could be solved relatively fast while the bigger issues would await a comprehensive review. A potential problem with such an approach could, however, be that the amendments made in the first round of changes might have to be amended again once a comprehensive review of IAS 7 is performed. Frequent changes in the same requirements could be considered as a situation that should be avoided as it would result in costs for both preparers and users and not be beneficial.

APPENDIX 1: INPUT COLLECTED BY EFRAG

A1.1 The table below lists the meetings and events EFRAG arranged for the purpose of collected input for this DP.

A1.2 {to be included}

APPENDIX 2: BIBLIOGRAPHY

{to be included}

{EU disclaimer to be inserted}