EFRAG Proactive Research Project: The Issues with how the IAS 7 Statement of Cash Flows is Prepared

zielke research consult

Content

Executive Summary

The objective of the first part of EFRAG's proactive research project is to understand the issues with how the IAS 7 Statement of Cash Flows is prepared with respect to corporates and financial institutions. We obtained information from the following sources:

- ✓ Academic Literature
- ✓ EFRAG working group meetings and statement of cash flows roundtable sessions
- ✓ Latest accounting manuals of auditing firms
- ✓ IFRIC Discussions
- ✓ Previous studies conducted by other regional financial reporting advisory groups

The objectives and uses of the statement of cash flows of corporates as identified in the part 1

The objectives and uses we idenditied in the first part of the project:

Objectives	Uses
1. Providing information about the financial structure of an entity. - Liquidity Information - Solvency Information	1. Assessing financial structure of an entity. - Liquidity - Solvency
2. Movements of cash and cash equivalents	2. Assessment of Management Stewardship
3. Interaction between cash balance and net income	3. Valuation purposes - Association with stock returns, prediction of future cash flows and providing information on accruals
	4. Explain business model of an entity
	5. Assessment of dividends
	6. Analysing Capital Expenditures

zielke research consult

The issues with the statement of cash flows of corporates

We discuss the issues related to the statemet of cash flows of corporates through the following themes:

- The Direct and Indirect Method
- Classification Issues
- Cash and Cash Equivalents

zielke research consult

The Direct and Indirect Method

IAS 7 (18(a)(b) – gives the flexibility for reporting cash flows from operating activities either through the direct or the indirect method.

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

zielke research consult

The Direct and Indirect Method

Academic Research on the Indirect Method:

- Academic research notes that most corporates reports cash flows from operating activities using the indirect method as it is easier to prepare than the direct method (Wallace et al., 1997, Troberg 2007, Broome, 2004 etc).
- Investors and analysts prefer the indirect method over the direct method as it provides reasons for differences between the net income and change in cash from operative activities (Brahmasrene 2004 & Anthony, 1997).
- The indirect method is much relevant to capital markets where the focus is on net income and earnings (Troberg, 2007).
- The indirect method could facilitate manipulation of the statement of cash flows as reported in the US (Broome, 2004).

The Direct and Indirect Method

Academic Research on Direct Method:

- The direct method provides users with a breakdown of cash inflws and outflows which makes it easy for users to understand unlike the indirect method(Broome, 2004 & Brahmasrene, 2004).
- The direct method is useful in predicting future cash flows due to the dissagregation of cash flows from operating activities into components (Farshadfar & Monem, 2013, Orpurt & Zang, 2009)

The Direct and Indirect Method

Roundtable session and EFRAG Working Group Meetings:

- Preparers highlighted that they prefer the indirect method as it provides investors with information such as operational cash flows.
- Some preparers had tried to draft a direct method but failed to come up with a solution.
- They would rather stick with the indirect method.
- An IASB observer also noted that most companies use the indirect method.

The Direct and Indirect Method

The direct and Indirect Method	Link to the Objectives / Uses
Information provided by the direct method	- Is not useful in understanding the interaction of cash balance and net income. - -Would not be useful in forecasting of cash flows for valuation purposes.
A possibility of statement of cash flows under the indirect method to be manipulated (EFRAG Academic Meeting, Broome 2004)	-Could distort information pertaining to providing information of the movements of cash and cash equivalents -Could affect the ability of the statement of cash flows in providing information pertaining to the financial structure.

Classification Issues

The classification issues have been categorized into the following categories:

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

Classification Issues

1. Transactions are not classified in a comparable manner:

- Transactions not classsified accurately as operating, investing and financing would lead to a material issue for investors.
- Single transactions include cash flows classified differently eg. Cash repayment of loan.
- Classification of cash flows as operating activities by default – whether it is a concern for preparers and users.
- IFRIC: definitions of operating, investing and financing could be made more clearer so that a consistent application of the primary principle of classification can be implemented by preparers.

Classification Issues

Any difficulties in classifying these transactions?

- ✓ Cash contribution to a long-term employee benefit fund (operating or investing?)
- ✓ Cash received as compensation for an insured losss (operating or investing?)
- ✓ Cash purchase for purchase of PPE on deferred payment terms (investing or financing?)
- ✓ Cash payment to meet rehabilitation obligation (operating or investing?)
- ✓ Cash received from a government grant (operating or financing?)
- ✓ Cash payment to a factor in a reverse factoring agreement (operating or financing?)
- ✓ Cash flows on initial or subsequent margin calls (operating, investing or financing?)
- ✓ Repayment of debt of an acquiree as a result of a change in control clause (investing or financing?)
- ✓ R&D expenses? (as highlighted by a preparer in the corporate roundtable session)

Classification Issues

Transaction not classified in a comparable manner	Link to objectives/uses
Inaccurate classification as operating, investing and financing	Affects the objective of the statement of cash flows in providing information about the financial structure, movement of cash and cash equivalents and interaction of cash balance with net income. This means that users would: -not be able to assess financial structure of an entity -understand business model -assess management stewardship
Definition of operating cash flows and classification of cash flows as operating activities.	Same as the above

zielke research consult

Classification Issues

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

- The issue of classification of interest and dividends existed but may have been partyl solved by the amendment following to IAS 7 as a result of the Primary Financial Statement project of the IASB.

Example : Cash flows from supply-chain financing and reverse factoring arrangements:

Issue – Does the presentation of the liability to the financial institution in the statement of financial position impact the presentation of cash flows? Example, if the liability does not relate to trade and other payables, should the payments to the financial institution be classified as a fiancing outflow? Or should it be presented as an operating cash flow because of the nature of activities that led to the initial recognition of trade payables?

(This was also raised in one of the roundtable session).

Classification Issues

Example: Receipt of government grants – IFRIC discussion have not given a conclusion with regards to presentation of cash inflows from government grants. Unavailability of clarifications would result into different practices by corporates (EY, 2024).

Classification Issues: Examples

Classification Issues	Link to objectives/uses
Supply chain financing and reverse factoring arrangements – difference in practices where preparers could report under financing and some other operating cash flow.	- Could affect the objective of providing information of movements in cash and cash equivalent due to differences in classification
Receipt of Government Grant – some argued that it should be classified under operating, and some argued under financing.	-As IFRIC has not issued a decision pertaining to this issues, the difference in classification may result in comparability issues.

zielke research consult

Classification Issues: Other Examples

These are other classification issues the could affect the comparability of the statement of cash flows:

- ✓ Payments to unfunded defined benefit pension schemes
- ✓ Cash payments related to the purchase of an asset on deferred payment terms.
- ✓ Cash received in a sale and lease back arrangement where the transactio qualified as a sale.
- ✓ Payments of variable consideration.
- ✓ How to classify cash received and cash payments related to derivatives that are collateralisd to market.

zielke research consult

Cash and Cash Equivalents

Uncertainties in what can be included as cash and cash equivalents:

- The challenges in assigning a definition of cash and cash equivalent which results into information not being relevant.
- Example of cryptocurrencies where in the event that it is acknowledged as a medium of exchange and becomes a basis where transactions have to be measured and recorded in financial statements – how will this be presented in the statement of cash flows.
- The exclusion of non-cash transactions which affects the relevance of information.

Cash and Cash Equivalents

Objectives /uses that are affected by uncertainties of cash & cash equivalents and exclusion of non-cash transactions
- The ability of the statement of cash flows to provide information pertaining to movements of cash and cash equivalents.
- Affects the ability of the statement of cash flows to provide information pertaining to the interaction between cash balance and net income.

zielke research consult

Input received from EFRAG FR TEG on 01.07.2024

- The direct and indirect issue is not an “issue” and should not be given a priority.
- Importance on the definition of cash and cash equivalents
- Discussion on definitions such as working capital, free cash flows are not important (out of the scope).
- Important to distinguish between the various financial institutions.
- Effect of business combinations should be discussed more and also additional disclosures.

Additional Disclosures - Corporates

- Breakdown of Capex: as highlighted by panel members in the roundtable session that information which distinguishes growth capex and maintenance capex should be disclosed which would be beneficial to users. It is also acknowledged that the breakdown of Capex could be done on the face of the statement instead of in the notes.
- Information on cash flows from operating and non-operating assets: this was raised by valuators as it was acknowledged as important to know the sources of cash flows from valuation standpoint.
- A store of future value: information pertaining to ‘store of near liquid assets’ which could be used in funding future investments and distributing it to shareholders.
- Working Capital Changes: investors prefer a separate disclosure of working capital changes as it enables understanding of components of working capital and how it influenced the overall working capital change.

Additional Disclosures – Relation to Objectives/uses identified

Additional Disclosures	Relation to the objectives/uses identified
Breakdown of Capex	- Relates to the usage of statement of cash flows in analysing capital expenditure as identified in part 1. -Could also relate to the objective of provision of information of movements of cash and cash equivalents as the breakdown could provide in depth information for the distinction of growth vs maintenance capex.
Cash flows from operating and non-operating assets	- Could be related to the usage of the statement of cash flows in assessing financial structure of an entity.
A store of near liquid assets	- Could be related to the usage of statement of cash flows in assessing dividing possibilities – as per the valuator’s view.
Working Capital Changes	- Related to the objective of provision of information pertaining to movements of cash and cash equivalents.

zielke research consult

Issues of the Statement of Cash Flows - Banks

- Liquditiy Information: the statement of cash flows does not provide relevant information pertaining to liquidty for banks as future cash flows of a banks are also determined by a bank‘s ability to produce future loans with appropriate funding (EFRAG DP-2015 & bank comment letters).
- Classification into operating, investing and fianncing activities: not useful for banks as compared to non-financial firms. Different maturity in different amounts of cash flow makes it difficult for users to asses where operational activity starts and ends (Torfason, 2014).
- Issue of direct and indirect: banks conduct large quantities of transactions daily thus the direct method does not provide information for users to asses financial structure and net asets. Both the indirect and direct method do not provide relevant information for users. (Deutsche Bank, 2009).
- Definition of cash and non-cash items: regional accounting standard setters argued that bank‘s cash and cash equivalent is volatile and the presentation of cash and cash equivalents of banks was not meaningful. (DRSC & DGR, 2016).

Issues of the Statement of Cash Flows - Insurance

- Limited academic research with respect to the statement of cash flows of insurance companies.
- The EFRAG DP 2015 did not have sufficient discussion pertaining to the issues of insurance companies‘ statement of cash flows.
- Insurance companies such as Allianz in their comemnt letters in 2009 remarked that analysts did not use the statement of cash flows but used the MVEC – Market Consistent Embedded Value for their analysis.
- Users of insurance companies financial statements require additional information that disitnguished cash flows of policy holders and shareholder in order to predict future cash flows – this is provided outside financial statements.

Additional Disclosures for Financial Institutions (Banks and Insurance Companies)

- Time series of a ratio – asset encumbrance ratio: users would be able to asses a bank‘s liquidity as it provides information on trends and developments compared to a single point in time (DRSC, 2016).
- Cash balance sheet: practice by French and European banks where funding structure if banks is provided (ANC, 2016).
- Liquiditiy risk infrormation with reference to IFRS 7 Financial Instrumets and IFRS 17 Insurane Contracts.
- Providing Information on free surplus: information on how free surplus is used as highlighted by analysts (EFRG DP 2015).
- Information on duration of assets and liabilities: highlighted by valuators as understanding of the sources of cash flows is important in valuation.

zielke research consult