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30 March 2017

Dear Mr Lennard

Improving the Statement of Cash Flows - Discussion Paper

We welcome the opportunity to comment on possible improvements to the Statement of Cash Flows which could be made at some time in the future in light of the IASB's project on Primary Financial Statements. The IASB has indicated that its plan is to follow closely the feedback received from the FRC's Discussion Paper.

Please note that the comments in this letter are made by RSM UK and do not reflect the opinions of the RSM global network who may at a later date respond to the planned IASB Discussion Paper on its Primary Financial Statements project.

We agree that improvements ought to be possible to a standard that was originally issued in 1992, and we note that some of the recommendations in the FRC's Discussion Paper are based on requirements that were incorporated in the old UK GAAP equivalent standard, FRS 1, which was originally issued in 1996.

Many of the arguments and counterarguments explored in the Discussion Paper have equal merit and it is likely that opinion will therefore be divided. Our view is that any changes must result in improvement for users of the financial statements and be limited to those that a) reduce diversity in the preparation of the statement of cash flows because this will enhance comparability between entities, or b) improve consistency between the primary statements.

As an exception to this, we note that the proposal to reconcile to cash rather than cash and cash equivalents arguably will neither reduce diversity or improve consistency with other primary statements; and indeed this proposal goes beyond the latest proposals of the IASB (as noted at its December 2016 meeting). However, as explained in our response to question 7, we recognise the shortcomings of the definition of cash equivalents and how this was addressed successfully, in our view, under FRS 1, which was applied in the UK for circa 20 years.

We are generally supportive of the proposals for improvement. Our responses to the specific proposals in the discussion Paper are set out in Appendix 1.

If you would like to discuss any aspect of this response please do not hesitate to contact Danielle Stewart, Head of Financial Reporting.

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Question 1

Do you have any comments on the discussion of the usefulness of information about cash flows?

We agree that the primary purpose of the statement of cash flows should be to enhance a user's understanding of performance rather than to report a measure of performance. If there is any consistent measure of performance indicated by a statement of cash flows it is the measure of liquidity. However, regarding this as a measure of performance would be confusing in the context of accruals based financial statements and the presentation of a statement of financial performance.

Reporting performance is, and should be, the purpose of the statement of financial performance; at its December 2016 meeting, the IASB noted from research as part of its Primary Financial Statements project that this statement is the main focus of the user's analysis. The statement of cash flows should not be a substitute or an alternative for this; rather it provides a useful bridge between the statement of financial performance and the statement of financial position, which enables a reader to appreciate how an entity's financial position has been impacted by its performance during the reporting period.

The statement of cash flows also provides a different perspective on the key activities of an entity, that is operating, investing and financing, in a way that is not apparent from the statements of financial performance and position.

However, the usefulness of the information it provides about cash flows could be enhanced by eliminating some of the diversity that exists in the preparation of the statement of cash flows due to the choices and lack of definitions in IAS 7. This same level of diversity does not exist for the other primary statements.

Question 2

Do you agree that notional cash flows should not be reported in the statement of cash flows, but that non-cash transaction should be transparently disclosed? If notional cash flows should, in your view, be reported, how would they be identified?

Yes - we agree that notional cash flows should not be reported in the statement of cash flows, but that non-cash transactions should be transparently disclosed

The purpose of the statement of cash flows is to report an entity's cash flows as they occur. This is what the statement purports to do. Entities may choose or indeed be required to undertake their operations in different ways, and some may be more or less successful in this. Such differences should be highlighted, as discussed in paragraph 1.25 of the discussion paper, rather than obscured by including notional cash flows.

The comparability that is needed in the preparation of the statement of cash flows can be achieved by more consistent classification and presentation of actual cash flows based on an entity's actual circumstances, rather than by including notional ones. Including notional cash flows would not result in useful information when making comparisons between entities as they are not real.

Comparability is needed between entities that enter into the same arrangements (so that they report them consistently) rather than between entities which do something different (e.g. one entity leases whereas another purchases a machine). As an example of diversity - there is no explicit guidance in IAS 7 in respect of factoring, although there is in respect of other financing arrangements such as leasing. Factoring, and invoice discounting, are now common arrangements and should be addressed in an updated reporting standard in order to reduce the diversity which exists in practice, depending on whether such transactions are viewed as financing or operating.

We agree that non-cash transactions should be transparently disclosed where they are material, and this requirement should be extended to non-cash transactions from operating activities, such as share based payments and share of profits from associates or joint ventures. Such disclosure is necessary to complete the picture of the alterations in an entity's financial position.

Question 3

Do you agree that operating activities should be positively defined or described?

Yes – this would aid consistency between performance statements

Operating activities should be more positively defined, and this definition aligned with key sub-totals in the statement of financial performance such as 'operating profit'. As noted in our response to question 1, we consider that the statement of cash flows provides a useful bridge between the statement of financial performance and the statement of financial position, and the extent of this usefulness depends on consistent definitions and classifications being used. A user's understanding of how an entity's operating profits have been converted into cash is enhanced if an entity reports its operating profit and its cash flows from operating activities consistently. We recognise that developing and aligning a definition of 'operating' may be challenging, however many entities in our experience report this sub-total.

Question 4

Do you agree that capital expenditure should be reported within operating activities rather than as an investing activity, with sub-total drawn before capital expenditure, and disclosure of the extent to which capital expenditure represents 'replacement' or 'expansion'?

Yes – this would aid consistency between performance statements

Reporting capital expenditure on property, plant and equipment ('operational assets') within operating activities in the statement of cash flows would be consistent with the allocation of its cost over time (i.e. through depreciation and amortisation,) within operating profit in the statement of financial performance. The non-cash depreciation and amortisation charges would simply be replaced with the actual cash flow incurred. Capital expenditure by a trading entity in respect of investment assets, say investment property, should continue to be reported in the statement of cash flows as part of investing activities.

A sub-total being drawn before capital expenditure on operational assets would highlight the extent to which the capital expenditure was financed from operations, and also aid comparisons with alternative performance measures, such as profit before depreciation and amortisation, which are widely reported in annual reports.

However, we do consider that when an entity acquires 'trade and assets' rather than an entity, and this meets the definition of a business, then the cash flows from that business acquisition should be reported within investing activities, consistently with other forms of business combination.

In the same way that distinguishing between capital expenditure that is replacement or expansion is difficult for presentation purposes, it is likely that narrative disclosure will not be possible without entities individually defining these terms based on their own views and business objectives. IAS 7.51 already encourages a similar voluntary disclosure, which in our experience is rarely made.

Question 5

What are your views on the reporting of cash flows relating to financing liabilities?

Removing the option of showing interest either within operating or financing cash flows would improve comparability between entities. Our view is that the classification of interest should be consistent with the classification of the related liability and so we agree that payments of interest on debt should be presented within financing activities. However, we think comparability between entities would be clearer if payments of interest were to be presented as a line item separate from repayments of principal so that a user of the financial statements can see readily whether an entity is only repaying interest or whether it is also repaying principal.

So, on balance, we believe it is appropriate to require payments of interest to be included as part of financing activities; however, we would prefer to see the separate presentation of interest, within that classification, from repayments of the principal.

Question 6

Do you agree that tax is best dealt with in a separate section of the statement of cash flows?

Yes - this would aid consistency between performance statements

Users of financial statements are generally interested in how much tax an entity pays, in total, from all of its activities. So, from the perspective of reporting cash flows, the analysis of tax payments by activity seems superfluous. Furthermore, classifying tax payments that are assessed on an entity's overall activities in respect of earlier periods by activity within the statement of cash flows can often be difficult to estimate reliably.

Referring to a single tax amount as a separate category in the statement of cash flows avoids either an arbitrary split or a default classification. It would also result in the statement showing both pre and post-tax cash flows, consistent with the reporting of profit or loss before and after tax in the statement of financial performance.

Question 7

In your view, should the statement of cash flows report flows of cash or of cash and cash equivalents? How, in your view, should cash and/or cash equivalents be defined, and why?

We note that this proposal goes beyond those of the IASB as part of its Primary Financial Statements project. However such a proposal is consistent with how entities in the UK have reported under old UK GAAP (FRS 1) for circa 20 years and is being made for the same reasons that 'cash equivalents' were rejected and the strict cash approach adopted under FRS 1. At the time, this proposal received widespread support.

Regardless of whether such a proposal would represent an improvement to the statement of cash flows through consistency between performance statements or comparability between entities, we do accept the shortcomings of the definition of cash equivalents (being arbitrary and subjective). We also recognise the difficulties in achieving a consensus on an acceptable definition (which proved difficult in the development of FRS 1).

With these shortcomings and challenges in agreeing an acceptable definition in mind, we would prefer to see the statement of cash flows report flows of cash only, with a requirement to also present separately an analysis of liquid resources and to explain liquid management policies. If such a change is made, consideration should be given to the current classifications in the statement of financial performance which requires investments to be split between cash and cash equivalents and other current financial assets.

Cash is easy for standard setters to define and can be applied consistently by all entities. The proposed changes in the discussion paper to the current IAS 7 definition of cash – to explicitly include reference to advances from banks and similar financial institutions, and that only these qualify as cash - would be helpful in our view.

However, the same cannot be said for liquid resources for the reasons discussed in the Discussion Paper. Nevertheless, meaningful information can still be presented by providing an analysis of liquid resources and requiring entities to explain their liquid management objectives and policies.

Furthermore, the recast statement of cash flows in appendix B of the discussion paper indicates the generation of cash both before and after movements in liquid resources. Users of financial statements can then form their own views as to the availability of additional resources which are similar to cash. Clear and separate presentation in the statement of cash flows is often all that a user needs to be able to make appropriate adjustments to obtain information that is useful to them.

Question 8

Which cash flows should, in your view, qualify for net presentation in the statement of cash flows?

For investments, in particular, that are continuously rolled over; or for a debt instrument that is reissued on substantially the same terms with the same counterparty; the reporting of gross cash flows can result in meaningless information. For this reason, we agree with the conclusion in the Discussion Paper that net presentation should only be permitted for those cash flows relating to financial instruments that are of the same class. However, we believe that explanatory guidance should be provided to explain what is meant by the same class and whether those instruments should be with the same counterparty as IFRS 7.6 does not do this far.

Question 9

In your view, is it appropriate to require the presentation of a reconciliation of operating activities in all cases, and to prohibit presenting it within the statement of cash flows?

Yes – this would aid consistency between performance statements and comparability between entities

We agree that such a reconciliation should be provided regardless of whether the direct or indirect method is used as it provides a bridge from the statement of financial performance and the statement of cash flows.

Developing and aligning the definition of 'operating' should in our view result in comparable preparation of the reconciliation, starting consistently with operating profit; and this starting point should also simplify and reduce the number of reconciling items.

Consistent with analysis for other performance statements, we agree that the reconciliation of operating activities should be presented in a separate note. Whilst for relatively straight forward entities this reconciliation could be quite short (particularly if the definition of 'operating' is aligned), we consider that in general the presentation of such a reconciliation on the face of the statement of cash flows would detract from its purpose of reporting cash flows.

Question 10

Do you agree that the direct method statement of cash flows should be neither prohibited nor required?

Yes – comparability does not appear to be an issue

Both methods have their relative advantages and disadvantages and the outreach indicates there is no overwhelming preference for either. In our experience, entities tend to favour the indirect method and so comparability has not been affected by the lack of an explicit requirement for one method or another. We see no reason to change the current position.

Question 11

Which components of cash flows from operating activities should an accounting standard identify as particularly significant, and why? How should standard-setters decide whether to require disclosure of the amount of such components or of changes in related working capital items?

We see no reason to require the disclosure of specific cash flows from operating activities or changes in related working capital items. Whilst investors may be 'frustrated' that the change in amounts reported in the statement of financial position cannot be reconciled to amounts reported in the statements of financial performance and cash flows (e.g. interest accruals), we suspect that this view is based on 'ease' of reconciliation rather than it not being possible. The disclosure requirements of other standards already provide the information required in respect of reconciling items which are likely to be significant for most entities, such as depreciation and amortisation, and impairment provisions. Requiring specific disclosures in respect of these items in the context of the statement of cash flows will merely add clutter to the financial statements.

However, we do perceive benefits from establishing a disclosure principle that cash flows in respect of operating activities that are considered to be 'significant' or 'material' (perhaps because of size or incidence) should be highlighted in the reconciliation. For example, a material one-off pension deficit payment.