By email to cashflows@frc.org.uk
Andrew Lennard
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

31 March 2017

Dear Sir,

Discussion Paper - Improving the Statement of Cash Flows

We welcome the opportunity to comment, on behalf of PricewaterhouseCoopers LLP, on the discussion paper on improving the statement of cash flows.

In response to the questions asked, we believe the objective of a cash flow statement goes beyond demonstrating liquidity and should equally be about measuring performance. We are supportive of the use of notional cash flows in limited circumstances, such as factoring, as we believe this gives useful information and we also support the view that cash flows in relation to principal and interest should be aggregated.

We have considered the general theme of the discussion paper which is to expand the sections of the IAS 7 cash flow statement beyond the three current categories. Our response concludes that we do not propose a return to the categories of FRS 1 but that we do support separately presenting tax cash flows as well as defining the scope of 'operating activities'.

Our view is that IAS 7's existing definition of cash and cash equivalents could be supplemented with clearer application guidance whilst the existing guidance on netting and the use of direct cash flow statements are fit for purpose. The requirements for the reconciliation to operating activities should not be overly prescriptive, instead relying on materiality but the reconciliation should be displayed prominently either on the cash flow statement itself or immediately afterwards.

Our detailed responses to the questions raised in the discussion paper are included in the appendix to this letter.

If you have any questions or would like to discuss any of the comments we have made in this letter, please contact Peter Hogarth on 0207 213 1654.

Yours faithfully

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP, 1 Embankment Place, London, WC2N 6RH
T: +44 (0) 20 7583 5000, F: +44 (0) 20 7212 4652, www.pwc.co.uk

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Appendix

Question 1: Do you have any comments on the discussion of the usefulness of information about cash flows?

We generally support the points raised in the discussion paper. We agree that accruals-based information provides a more relevant measure of performance than cash-based information. We do feel, however, that cash flow statements remain a valuable indicator of performance. The conversion of profits to cash is a significant indicator of performance and free cash flow is a key metric used by investors. The increasing use of adjusted performance measures (APMs) that exclude non cash impacts indicates that companies are looking to present performance closer to a cash basis, sometimes at the expense of GAAP information. An evolution of the cash flow statement to help users better identify cash performance may help to limit the reliance on these types of APMs that mix profits and cash and bring about greater balance of discussion in the front half of the annual report.

Question 2: Do you agree that notional cash flows should not be reported in the statement of cash flows, but that non-cash transactions should be transparently disclosed? If notional cash flows should, in your view, be reported, how would they be identified?

We believe that it is important to be wary of reporting notional cash flows. Our expectation is that the cash flow statement should only reflect genuine cash flows unless reporting a notional cash flow produces more relevant and meaningful information for the user . Circumstances such as factoring are an example where presentation of notional cash flows may be beneficial in some instances. The approach considered in paragraph 1.27 is consistent with the guidance we already provide in the PwC IFRS Manual of Accounting, where derecognition of factor liabilities are presented as financing outflows. We agree with the points raised in paragraph 1.25 that notional cash flows should not be presented for leases given the inherent differences in the economic position of leases compared to asset purchases.

The presentation of notional cash flows should be clearly articulated in the accounting policies. In addition, regardless of whether notional cash flows are reported or not, we support greater transparency in the disclosure of non-cash transactions, including those excluded in the reconciliation to operating activities.

Question 3: Do you agree that operating activities should be positively defined or described?

Yes, we are supportive of a clearer definition or description of operating activities rather than a catch-all default classification. The definition should not be overly prescriptive or inflexible but look to align itself with the operating profit of the entity, which in itself may require IAS 1 to positively define 'operating profit'. IAS 7 provides useful examples of items expected to be presented as financing or investing activities whilst still permitting some judgement. A similar approach to the definition of operating activities would be beneficial.

As stated in our response to question 1, users of the financial statements do look at both the cash flow and income statement to determine operating performance and therefore it is important that the two statements reflect a consistent presentation of performance that then allows genuine disparities between cash and profit performance to be identified and explained.

We concur with the statement in paragraph 2.4 that "it should be clear that items should not be excluded from 'operating activities' simply because they are unusual or non-recurring." A concern with narrowing the definition of operating activities, however, is the treatment of the residual which would not fall into any of the three categories and the potential for companies to use an 'other' cash flow category to alter the perception of performance by excluding 'non-core' operations or unfortunate cash outflows.

Any expansion of the definition should come alongside the requirement to clearly disclose and provide additional notes if necessary on any items that are considered to fall outside any category of the cash flow statement. This will ensure that any items judged to be residual are clearly explained and justified. We believe there should be very few items that would fall outside operating, investing and financing cash flows as defined and in practice, we would expect use of this category to be rare. The issue of non-operating cash flows could alternatively be addressed using the materiality guidance of IAS 1 and the use of sub-totals within the operating activity section to highlight these items without the need for a residual category.

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'?

We do not agree that capital expenditure should be reported within operating activities. By creating a sub-total within operating activities, capital expenditure effectively becomes a separate section of the statement. We believe the presentation within investing activities draws clearer attention to capital expenditure and is consistent with the existing definition in IAS 7.

We are supportive, in theory, of the separation of disclosure of capital expenditure into 'replacement' and 'expansion'. This would provide users a clearer understanding of recurring outflows as well as insight into the cash cost of growth plans. However, in practice, the obstacles to providing a basis of allocation that is comparable and accurate may make this proposal unfeasible. A high hurdle may prove effective but still leaves judgements that are likely to fall towards 'expansion' given the incentive to do so.

An alternative solution of encouraging the disclosure of management's assessment of the capital expenditure required to remain at a steady state would be a more realistic outcome.

Question 5: What are your views on the reporting of cash flows relating to financing liabilities?

We agree with the view that cash flows for financing liabilities should reflect the nature of the liability itself, such that cash flows on customer related liabilities are classified within operating activities whilst debt financing remains as is.

We are supportive of the view that the distinction between cash interest and principal is not necessarily beneficial in the cash flow statement, especially in scenarios where interest costs are imputed. This will become more prevalent with the adoption of IFRS 16 Leases as lessees start using amortised cost models for lease liabilities with the added impact of lease incentives such as rent free periods. This creates unneeded complexity when it is unclear from a cash perspective, the extent to which the repayment of a liability, or indeed receipt of cash, includes interest. The combination of the principal and interest in a single line within the applicable classification depending on the nature of the liability achieves the objective of demonstrating the relevant cash flows on financing liabilities.

Alongside the above, a net debt reconciliation as suggested by IAS 7, paragraph 44D that demonstrates the movement from opening to closing net debt, separately presenting interest and cash flows, would effectively link three of the primary statements and give a user a clear picture of the use of financing. Clear disclosure would be needed here such that users can reconcile the income statement interest charge and the cash flows relating to the financing activity.

Thinking of IFRS 16 more widely, the impact on the cash flow statement will be especially pronounced for companies currently heavily reliant on operating leases, such as retailers. A substantial amount of cash flows will shift classification to financing activities resulting in a scenario where the operating activities exclude a cash flow that forms a core part of the business model. This raises the interesting question of how then to align the aim of a positive definition for operating activities, as discussed in our response to question 3, and reporting financing cash flows in accordance with their nature. There may be an argument to look through the form of the cash flow and instead consider the underlying purpose when looking at the classification/definition of operating activities. This is a question that the FRC might usefully consider further.

Question 6: Do you agree that tax is best dealt with in a separate section of the statement of cash flows?

Yes. We believe the separation of tax from other activities provides greater transparency to the user and would encourage preparers to consider the impact of their wider tax disclosures more thoroughly with regards to areas such as long term tax rate sustainability or cash versus expense variances.

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, on balance, do not believe that the statement of cash flows should move to purely reporting cash and including other liquid resources in a separate section. Whilst at first sight this might seem a purer solution, the use of other assets to manage liquidity is on the rise given the low interest rate environments in many developed countries and so reconciling only cash may hinder the view of liquidity. Similarly many companies use cash equivalents such as overdrafts or short term deposits as a fundamental part of their treasury processes to the extent that focusing solely on cash is not reflective of their management of liquidity. The investor community, too, focus on liquidity rather than simply cash.

The current definition of cash and cash equivalents provides a good starting framework. The definitions in place are not rigid and guidance such as a three month maturity period are only indicative, not conclusive, examples of a cash equivalent. However there are instances such as restricted cash, term deposits with withdrawal penalties and money market funds where the flexibility in the standard can lead to diversity in practice for which application or illustrative guidance to align and clarify treatment would be welcomed. We also note that as financial institutions develop more and more complex and exotic financial instruments, it may become necessary for further application guidance to be provided in order to ensure the spirit of the standard is maintained.

Under the existing reporting framework, if there are significant judgments made in respect of classification, then these should be disclosed but these type of judgements can be reduced if greater application guidance is provided.

Question 8: Which cash flows should, in your view, qualify for net presentation in the statement of cash flows?

As with the previous question, we believe that the current guidance on net presentation is working well in practice and that issues that arise can be effectively resolved through application guidance as was the case with the recent IFRIC agenda decision on cash pooling.

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, we think that a reconciliation of operating activities should be provided in all cases in order to bring together the income statement, statement of financial position and cash flow statement. If, as we suggest in response to question 3, both operating activities and operating profit are specifically and similarly defined in IFRS, then a logical starting point for the reconciliation emerges.

We believe that presentation of the reconciliation within the statement of cash flows should be encouraged, rather than prohibited, to give the user an immediate understanding of the linkage between the primary financial statements. If the reconciliation is not presented within the statement itself, it should be presented immediately afterwards to aid the user, rather than being buried within the notes to the accounts.

Question 10: Do you agree that the direct method statement of cash flows should be neither prohibited nor required?

Yes. The direct method has its advantages and disadvantages, however to prohibit or mandate it will add unnecessary time and effort to conform to a single method for limited benefit beyond comparability with a limited number of countries who typically use the direct method.

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 do not believe that the standard should prescribe specific items within operating activities as individually significant but reinforce the principles of IAS 1 to separately present material line items and avoid over aggregation. This should lead to, for example, a working capital reconciliation that splits out accounts receivables from customers given it is typically individually material. A compromise would be for the standard to expand paragraph 20 to suggest greater disaggregation of the main line items. Ultimately if an item is material in the other primary statements, the related cash flows should be presented separately.