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April 11, 2017

Mr Andrew Lennard
Financial Reporting Council
125 London Wall
London, EC2Y 5AS

Re: Discussion Paper, *Improving the Statement of Cash Flows*

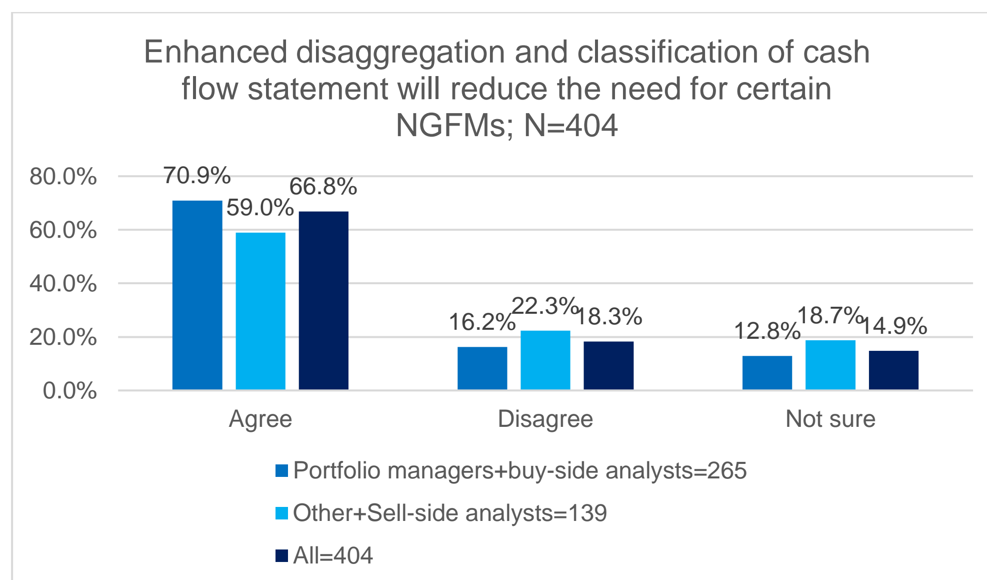
Dear Mr Lennard,

CFA Institute[1]is pleased to provide you with our perspectives on areas for consideration on the UK Financial Reporting Council (FRC) discussion paper on improving the statement of cash flows (herein referred to as "discussion paper").

We welcome the FRC's detailed review of the cash flow statement as it has been a long neglected financial statement from a standard setting point of view despite the information contained within it being integral for assessing the liquidity, working capital management, and quality of earnings reported by companies. Furthermore, we contend that in many cases, the use by investors of certain Non-GAAP financial measures (NGFMs) such as "free cash flow" and "Earnings Before Interest Tax Depreciation and Amortisation (EBITDA)" as proxies for cash flows, is indicative of less than adequate cash flow statement information. A recent publication (*Investor Uses, Expectations and Concerns on Non-GAAP Financial Measures)* showed that there is widespread support (66.8% of respondents) for the enhanced disaggregation and classification of the cash flow statement as a way of reducing the need for NGFMs (see Figure 1).

[1] CFA Institute is a global, not-for-profit professional association of more than 137,000 investment analysts, advisers, portfolio managers, and other investment professionals in 157 countries, of more than 131,400 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 147 member societies in 73 countries and territories.

Figure 1: Member views on Enhanced Disaggregation and Classification of Cash Flow Statement



CFA Institute has consistently advocated for the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) to improve the presentation of the three main financial statements (2007 publication- Comprehensive Business Reporting Model (CBRM); 2009 comment letter on the Financial Statement Presentation discussion paper; 2016 IASB agenda consultation letter). Hence, our response to the discussion paper is shaped by an anticipation that the FRC's review of the cash flow statement will inform the work by the main accounting standard setters on primary financial statements and help to build on previous proposals for enhancing the presentation of the main financial statements that were made under the 2008/2009 discussion paper on Financial Statement Presentation ("FSP").

In this letter, we recommend that the following principles should guide the enhancement on the cash flow statement:

- Enhanced definition, disaggregation and classification of cash flow statement;
- Meaningful cohesiveness of cash flow and income statement categories;
- Ensuring consistent classification across companies; and
- Enhanced disclosure of non-cash items

Our discussion of the above forms of enhancement encompasses the proposals contained within the discussion paper.

Enhanced definition, classification and disaggregation of cash flow statement

- *Recommend predefined cash flow statement categories that enable comparability*: Cash flow statement should have predefined categories rather than entities having the flexibility to determine cash flow categories as this latter option would undermine comparability of reporting entities. As shown in a 2007 CFA Institute survey, there was investor preference (71.6%) for predefined categories and very limited support (3.8%) for companies to have total flexibility to define cash flow activities in a way that they think is appropriate.

Figure 2: Member views on categories of cash flow statement

Under IFRS and US GAAP, companies are required to disaggregate and present separately cash flow information by the following activities: operating, investing and financing. In these current standards, investing and financing activities are defined and operating activities are all other activities not defined as investing or financing. The survey question was how should cash flow activities be defined?	**Number of responses**	**Percentage response**
Cash flow activities should be predefined similar to current standards	272	71.6%
Cash flow activities should have some broad definitions; companies should have some flexibility to define cash flow activities in a way that they think is appropriate	91	23.9%
Cash flow activities should not be predefined; companies should have the flexibility to define cash flow activities in a way that they think is appropriate	8	2.1%
Total	380	100%

Excluded 2.4% (9 respondents) had no opinion.

- *Support a review and potential expansion of the current three-category cash flow statement:* We support a review of the current three-category structure (operating, investing and financing). We recommend defining and moving away from treating operating cash flows as a residual category. As noted earlier, investors' widespread application of Non-GAAP liquidity measures is indicative of the need for greater disaggregation of existing cash flow statement categories- particularly operating cash flow. Furthermore, a 2009 CFA Institute member survey showed investors desire greater disaggregation of operating cash flow with support for disaggregation on the following information components:
  - Cash revenue collections from core business activities (94% considered it either important or very important)
  - Working capital changes (91% considered it either important or very important)
  - Operating cash flow at segment and business subsidiary (83% considered it either important or very important)
  - Expenses paid to suppliers (80% considered it either important or very important)
  - Expenses paid to employees (75% considered it either important or very important)

  We would support standard setter efforts to either define or describe both operating activities line items that are consistently presented in the cash flow statement and income statement. In other words, if standard setters establish an operating activities

category in the income statement, that definition or description should be considered when redefining operating activities for the cash flow statement such that the two statements would have the same meaning of operating activities.

In the CBRM publication, we also argued in favour of a strict definition of financing category such that it only includes third-party financing related items. A corollary of a stricter definition of operating and financing cash flows could be the need for a new residual category. Hence, we would not be opposed to a fourth cash flow statement category that is residual in nature.

- *Support the requirement of direct cash flow statement*: CFA Institute has long supported a requirement of the direct cash flow statement as this format provides greater and meaningful disaggregation of the underlying cash flow components. By construction, the direct cash flow statement provides more information than the indirect cash flow statement due to its greater disaggregation of the operating cash flow category. Consequently, standard setters should continue to seek answers to the following matters:

  a) *Ascertain Incremental Information Content*: It is valid to pose the question of whether there is really incremental, useful information within the direct cash flow statement information? Our 2009 comment letter on the Financial Statement Presentation discussion paper presents our comprehensive reasoning in support of the direct cash flow statement. Furthermore, there is a growing body of evidence showing the relevance of components of the direct cash flow statement. For example, a recent 2017 Financial Analyst Journal publication (Are Cash Flows Better Predictors of Returns Than Profits?) finds that direct method derived cash flow from operations is a better predictor of returns than income statement derived summary performance measures.

  b) *Address Concerns about Loss of Indirect Cash Flow Statement Information*: Some stakeholders hold the view that the requirement of direct cash format can result in loss of useful information that is currently provided under the indirect cash flow statement that investors desire (e.g. working capital changes). In the aftermath of the FSP deliberations that occurred a few years ago, there remains a need for standard setters to have follow-up outreach to investors to ensure a full familiarity with the perceived pros and cons of both the direct and indirect cash flow statement and to ensure a precise understanding of the components of both formats of presentation. For example, a required reconciliation of operating cash flow to income statement summary measure under both formats of the cash flow statement should assuage any concerns about loss of information on working capital changes.

  c) *Review Validity of Implementation Concerns*: During the FSP discussion paper deliberations, a common reservation aired by opponents of the direct cash flow method was the anticipated prohibitive costs associated with this approach. There were also assertions around the difficulties in aggregating and consolidating cash flow statement from a subsidiary level. As several years have elapsed since standard setters sought preliminary views from

stakeholders on the FSP project, we recommend that standard setters should update its cost-benefit analysis of a direct cash flow method requirement, including assessing if and to what extent advances in reporting technology may have lessened these preparer concerns and therefore increased the feasibility of implementation of the direct cash flow statement.

- *Support reconciliation of operating cash flow to income statement summary measure*: We agree with the need to reconcile the operating cash flow to an income statement summary measure regardless of the format of the statement of cash flows, as this will help provide useful information on working capital changes and non-cash items. Ideally, the reconciliation ought to start from an operating income sub-total but this sub-total has not and might be difficult to define in a fashion that is appropriate for all companies. Hence, net income remains a suitable starting point for the reconciliation.

- *Support the proposed disaggregation of investment expenditure*: We support the discussion paper's proposed disaggregation of investment expenditure into replacement and maintenance categories.

Appropriate cohesiveness[2] across income and cash flow statements

Ideally, we would prefer if the income statement and cash flow statement classification categories were guided by the principle of cohesiveness as was being considered during the FSP project. However, the pursuit of the cohesiveness principle should not constrain the objective of respectively enhancing the disaggregation and classification of the income statement and cash flow statement in the best possible manner. In other words, the same classification approaches should not be applied to these two statements if it means eliminating useful classification categories particularly if one considers that the three-category classification of cash flow statement (operating, investing and financing) is more developed than that of the income statement. Hence, we do not support the option of changing the classification categories of cash flow statement to be less than the current three categories simply to be consistent with any income statement classification.

As noted earlier, if standard setters establish an operating activities category in the income statement, that definition or description should be considered when redefining operating activities for the cash flow statement such that the two statements would have the same meaning of operating activities.

Ensure consistent classification of all cash flow items

An IASB staff paper (IFRS Accounting Choices: An Impediment to Comparability?), discussed by the Capital Markets Advisory Council (CMAC), reflects investor concerns regarding the inconsistencies in classification of items on the main financial statements. We would recommend an extended outreach to investors to identify inconsistencies in the classification items that investors observe and find problematic as they analyse and compare companies cash flows (e.g. dividends, interest and cash flow for hedging instruments). The need for a comparable classification approach further underpins our support for the recently issued US FASB guidance (ASU-Statement of Cash Flows (Topic 230)- *Classification of*

[2] Cohesiveness means similar classification of transactions across different financial statements.

Certain Cash Receipts and Cash Payments) that aimed to reduce diversity in practice including that related to the "interest payment portion" on zero coupon bonds and for cash flows with multiple elements that are classified according to the predominant[3] nature of the transaction. An equivalent revision to guidance should occur for IFRS standards.

Cash flow statement should not reflect "notional" flows
We agree with the conclusions of the discussion paper that the cash flow statement should not represent "notional" cash flows (e.g. Acquiring a fixed asset using a finance lease, barter transactions, share-based payments, unfunded pension obligations and acquisitions where consideration is in the form of equity). Robust disclosures should be adequate to provide transparency around non-cash economic transactions. Such disclosures can enable users to construct cash equivalent scenarios and to make comparisons between companies that engage in cash transactions and those that undertake economically equivalent non-cash transactions.

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Thank you again for the opportunity to comment on the discussion paper. If you or your staff have questions or seek further elaboration of our views, please contact Vincent Papa, Ph.D., CPA, CFA by phone at [redacted], or by e-mail at [redacted]

Sincerely,

/s/ Vincent Papa

Vincent Papa, Ph.D. CPA, CFA
Interim Head, Financial Reporting Policy
Standards & Advocacy Division
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[3] Determining the predominant nature is a required management judgement that can result in differing cash flow statement classification choices for similar transactions.