

3 April 2017

Direct phone: [REDACTED]

Andrew Lennard
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By email to: cashflows@frc.org.uk

Dear Mr Lennard

Discussion Paper: Improving the Statement of Cash Flows

Deloitte LLP welcomes the opportunity to comment on the Financial Reporting Council's Discussion Paper: *Improving the Statement of Cash Flows*.

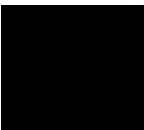
We agree with many of the suggestions made in the paper to improve the statement of cash flows. We believe that the focus should be on improving classification and we support introducing more classification headings. However, we believe that less emphasis should be afforded to suggestions made where the existing principles and rules in IAS 7 *Statement of Cash Flows* are operating successfully in practice and are not considered to be significant problem areas such as net presentation and where the reconciliation of operating activities should be presented.

We also consider that several of suggestions could be enhanced through further outreach to determine whether the issue raised is an important one for users of financial statements and to strike the appropriate balance between costs and benefits.

In addition to our comments above, we have set out our responses to the questions raised in the discussion paper in the Appendix to this letter.

We would be happy to discuss our letter with you. If you have any questions, please contact Ken Rigelsford on [REDACTED] or Dave Rice on [REDACTED]

Yours sincerely



Veronica Poole
National Head of Accounting and Corporate Reporting
Deloitte LLP

Appendix Responses to detailed questions

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

There are probably two main objectives a statement of cash flows could have:

- to report liquidity and funds management;
- to assess where cash is being generated and used, complementing the accrual-based statement of comprehensive income and statement of financial position.

The discussion paper suggests that the statement of cash flows should primarily be about reporting liquidity. We do not believe that this has historically been the approach used by the IASB.

It is important for the statement of cash flows to have a clear objective. Once the purpose is clear, the solutions to many of the questions raised in the discussion paper become more apparent. If better liquidity information is sought this could be addressed directly. If the current objective in IAS 7 *Statement of Cash Flows* is not as clear as it could be, then it should also be improved.

In addition, we do understand that investors and analysts consider a measure of 'free cash flows' and changes in this measure year on year to be important information. We suggest further outreach to determine what, if anything, could be done to improve the reporting of 'free cash flows' to assist users in this regard.

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?

Whilst we agree that notional cash flows should in principle not be reported in the statement of cash flows and that non-cash transactions should be transparently disclosed, in our view the more fundamental issue is how cash flows should be classified. We therefore believe that the focus of improving the statement of cash flows should be on classification and classification headings.

As can be seen in the examples on leases, debt factoring and reverse factoring discussed in the paper, there is clearly a relationship between the issue of notional cash flows and the issue of how cash flows should be classified. For instance, whilst we agree it is not appropriate to include notional cash flows to reflect the inception of a lease, we believe that an issue to be addressed is how the subsequent cash flows on a lease should be classified. In our view, classifying the capital elements of lease payments as a financing outflow does not fairly present the nature of these cash flows. This is because this treatment leads to an overstatement of financing outflows and an understatement of investing cash flows (or operating cash flows – see our response to question 4 below). However, the interest component should be treated as a financing cash flow (or 'returns on investments and servicing of finance' – see our response to question 5 below).

Debt factoring raises similar classification issues. Specifically, we consider that irrespective of whether a factoring arrangement results in derecognition, the receipts from the factor should be classified as operating cash flows rather than financing cash flows because they are, in substance, the receipts from trade customers. Furthermore, if a factoring arrangement does not result in derecognition, we consider that only the movement on the financing creditor should be treated as a financing cash flow (or 'returns on investments and servicing of finance' – see our response to question 5 below). This is because this treatment results in operating cash flows including cash flows from the customers as if the factoring had not been entered into. It also results in showing financing cash flows as if the customer balances had been financed by a loan. Finally, it also reflects the IAS 7 definition of financing activities as those "that result in changes in the size and composition of... borrowings".

For reverse factoring, if it is determined that the customer has a financing arrangement, rather than a trade payable, then, mechanically, it seems that there is only a financing cash outflow. Some might argue that this results in a distortion of operating cash flows because the customer has purchased goods or services and never has an operating cash outflow. An alternative view is that the customer should present a 'notional' operating cash outflow and financing inflow at the time the reverse factoring arrangement has been entered into. Whilst we do not necessarily agree with this view, it does raise the question: is disclosure of non-cash transactions sufficient or is the 'net operating cash flow' metric so important that another approach is needed? This is the nature of question that we believe the FRC should be considering, or encouraging the IASB to address, if clarity in this area is to be improved.

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

Whilst we agree that this is a good idea because it will contribute to a more consistent application, before embarking on the difficult task of defining positively operating activities, it may be worthwhile to carry out further work on the extent to which there are currently elements that are captured inappropriately as part of operating activities, because it is a residual category. There should also be a consistent linkage to amounts included in operating profits in the statement of comprehensive income ('SOCi'). We understand that the IASB will be considering positively defining 'operating profit' for the purposes of the SOCi in their primary financial statements project.

In addition, we believe it would be beneficial to users to align the SOCi and the statement of cash flows. This is predicated on the assumption that an entity will have structured its SOCi in the way it considers provides the best information for investors. This would mean no specific guidance about recurring or non-recurring cash flows is necessary. Using the example provided in the discussion paper of hostile takeover costs, when an entity presents a separate line item in the SOCi for such costs (as might be expected given the specific/uncommon nature of such costs) it would be appropriate to present the cash flow equivalent in the statement of cash flows.

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 agree with the proposal to report capital expenditure within operating activities but as a separately disclosed component after a sub-total. This is because, as the SOCi does not make such a distinction classifying capital expenditure as an investing activity is unnecessary. However, disclosure of the extent to which capital expenditure represents 'replacement' or 'expansion' should not be required. This is because, as identified in the paper, the distinction between replacement and expansion is difficult to apply in practice and may be arbitrary in many cases.

Putting the practical difficulties aside, separating capital expenditure into replacement and expansion suggests a broader purpose for the statement of cash flows. Presumably it is about signalling growth and other changes in the structure of the entity. If this information was helpful, we might also expect to see it for other items such as inventory or even staffing costs. But reporting such information seems beyond the expectations of what a statement of cash flows could reasonably be expected to report.

We believe that whether the consideration of a business combination should also be classified as an operating outflow is an issue which requires further research and consideration. For example, there may be a need for broader consideration of such a classification for the purchase of shares of an entity that holds a single asset, or the purchase of shares of an associate when income from the associate is classified as part of operating activities.

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

We are in favour of reducing the number of options that are currently available in IAS 7 for classifying cash flows relating to financing liabilities in order to enhance comparability. However, instead of requiring the payment of interest to be reported in the financing category, we would support including a separate classification heading, for 'returns on investments and servicing of finance' as used to be included in FRS 1. However, in our view the amounts reported under this heading should be consistent with amounts reported in the financing section of the SOCI, and therefore should also include implicit interest.

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

We agree that tax is best dealt with in a separate section as it is not part of operating cash flows.

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?

It may be overly restrictive to require the statement of cash flows to report flows of cash rather than cash and cash equivalents. Furthermore, the result may not be automatically better as there are likely to be issues in defining cash very narrowly. For example, borrowings that become repayable on demand in the event of default would appear to be included in the proposed definition of cash in paragraph 3.13 of the paper. We do not believe this to be correct, nor the intention of the proposed definition, but is one example highlighting the difficulty that could arise if cash were to be defined very narrowly.

In addition, the paper explains that the guiding principle is that cash should be instruments that can be used to pay expenses and meet financial obligations. We agree that the purpose for which an instrument is held is an important principle. IAS 7.7 requires that cash equivalents are held for the purpose of meeting short term cash commitments rather than for investment or other purposes. To address this issue, a 'purpose' principle could be included in any proposed definition of cash.

We believe that whether the statement of cash flows should report flows of cash rather than cash and cash equivalents is an issue requiring further outreach to determine whether this is a significant area of concern for users of financial statements.

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

In our view the existing requirements in IAS 7 operate satisfactorily in practice and we do not see net presentation as a significant problem area.

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?

We agree that the reconciliation of operating activities provides useful information and should therefore be included in all cases. The reconciliation can help pinpoint to a user why the accrual and cash flows differ. We also agree that if 'operating profit' is positively defined by the IASB it is more sensible to reconcile to this line in the SOCI. Whilst we appreciate the theoretical point relating to prohibiting the presentation of the reconciliation within the statement of cash flows, we do not consider this to be a major issue in practice. We believe that most users find presentation of the reconciliation within the statement of cash flows useful.

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

We agree that the direct method statement of cash flows should be neither prohibited nor required for deriving 'cash flow from operations'. That said, we also believe that the merits of the direct method should be further debated. This is because the objective of the statement of cash flows naturally leads to reporting

gross cash flows (the direct method) being the most intuitive and informative approach. However, further outreach is necessary to establish which method users of financial statements prefer and the additional costs that would be involved if the direct method were to be required.

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 have any comments on which components of cash flows from operating activities should be identified as significant and therefore require disclosure. We agree that further outreach is required to determine which components users would like to see disclosed and to judge the appropriate balance between costs and benefits.

