



# Disclosures on the sources and uses of cash

**A Lab project report**

September 2019



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## Examples used

Our report highlights some examples of current practice that were identified by the Financial Reporting Lab (Lab) team and investors. Not all of the examples are relevant for all companies, and all circumstances, but each provides an example of a company that demonstrates an approach to useful disclosures. Highlighting aspects of reporting by a particular entity should not be considered an evaluation of that entity's annual report as a whole. Investors have contributed to this project at a conceptual level. The examples used are selected to illustrate the principles that investors have highlighted and, in many cases, have been tested with investors. However, they are not necessarily examples chosen by investors, and should not be taken as confirmation of acceptance of the company's reporting more generally.

## Responding to feedback

In 2019 the Lab ran a stakeholder survey. As part of this survey we asked users of the reports for feedback. We received feedback that the example disclosures were of particular value to users. Responding to this feedback, we have included more examples within this report than in previous Lab reports. Whilst it makes the report longer, we hope it adds to the overall value of this report.

If you have any feedback, or would like to get in touch with the Lab, please email us at:

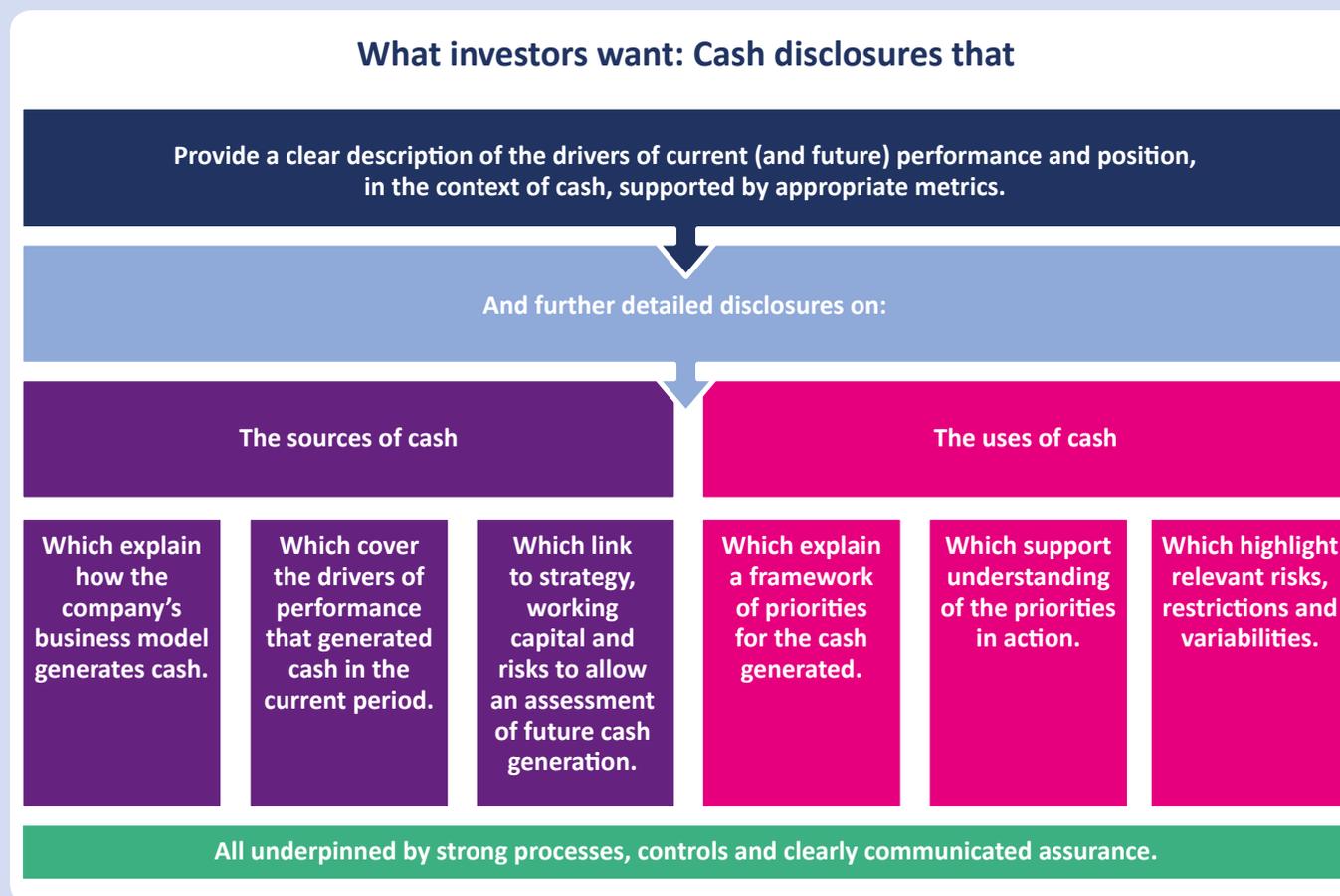
[financialreportinglab@frc.org.uk](mailto:financialreportinglab@frc.org.uk)

## Quick read

The understanding of the generation, availability, and use of cash is fundamental to the investment process, both in the assessment of management's historical stewardship of a company's assets, and in supporting analysis of future expectations. The core disclosure that supports these investor needs is the cash flow statement. This clearly provides information about the flow of cash (and equivalents), but does it do a good job of explaining how that cash is, and more critically will be generated and used? Our project would suggest that the disclosures that are most helpful to investors in answering their questions about cash are often provided outside of the cash flow statement, and may be outside of the annual report completely. This report focuses on this supplemental cash flow disclosure; disclosures that are principally about the sources and uses of cash.

### What do investors want?

Investors told us that what they want, at a high-level, is an overall discussion on a company's cash drivers, supported by further details. We have summarised their needs into the following model, and used this model as a structure to explore the topic in more detail.





## Sources of cash

Investors want disclosures that:

**Provide details about sources of cash, both now and in the future.**

In [section 2](#) of the report we explore views on disclosures that provide information on the sources and generation of cash.

Understanding the link between the operations of a company and its generation of cash is a key objective for investors. However, this is not always easy to do from the information a company discloses in the annual report. Investors participating in this project noted that there can be a lack of clarity, and it can be challenging to understand how the operations of the business are generating cash.

## Business model and cash

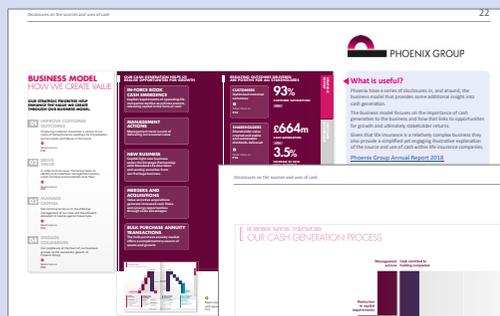
Whilst the business model disclosure is not the only place investors will go for information, for many it remains an important starting point, especially for those new to the business. As such, it is important that the disclosure either clearly explains how and where cash is generated, or references relevant disclosure throughout the rest of the report.

Key aspects of cash generation that could be enhanced in the business model, and related disclosures include:

- Disaggregation of profit generation, by product line, segment or geography (whichever is most relevant), and
- Detail around conversion of profit into free cash (or other cash metric, as selected by the company).

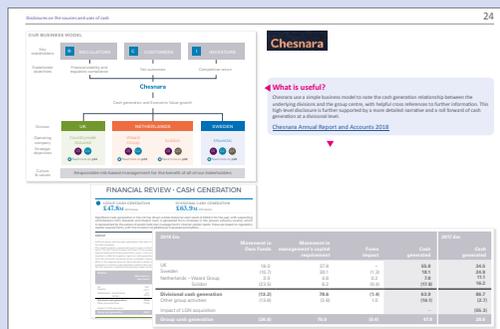
Examples that answered some of the investors' questions in this area included [Phoenix group](#), [Chesnara](#) and [Rio Tinto](#).

## Examples that explained how cash is generated



### Phoenix group

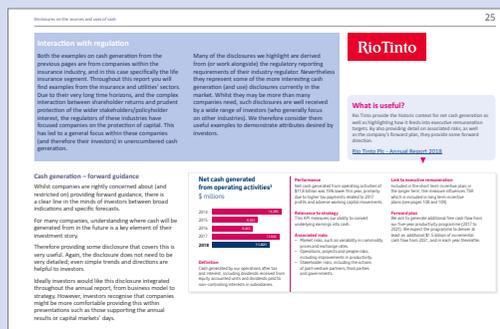
A business model disclosure that explains how cash is generated in simple terms.



### Chesnara

A business model that drills down to the underlying businesses and their ability to generate cash.

## An example focused on the future



### Rio Tinto

Contextualised performance indicators with some forward directional information.

## Connecting cash and working capital

Whilst the generation of cash is important, to fully understand the health of a business, investors also need to understand a company's approach to working capital. Investors participating in this project noted that they seek disclosures that help them understand the particular company – so that they can better model its future value – and also understand how changes in the operations flow through to the business, allowing them to better appreciate current performance and future risks.

Areas of disclosure that could be improved include:

- Where businesses within a single company have very different working capital requirements or approaches,
- Where changes to working capital processes are driving overall cash generation, and
- Where a specific approach to financing, such as factoring or reverse factoring needs to be understood to fully comprehend the company's approach to working capital.

Examples that provide relevant information include [Mears](#), [Johnson Maththey](#) and [AstraZeneca](#).

## Examples which focus on working capital include:

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**MEARS**

**What is useful?**  
In this extract Mears provide a narrative description of how different parts of the Housing division operate, and they support this with numeric disclosure. This helps investors understand the dynamics of the business better and provides a bridge between the group overall strategic objectives and what it means for individual components of the business.

**Annual Report and Annual Performance Report 2017/18**

	2018			2017		
	Revenue £m	Operating profit £m	Margin %	Revenue £m	Operating profit £m	Margin %
Maintenance	274	28.0	10.2%	508.0	23.9	4.7%
Management	125.4	8.5	6.8%	133.9	5.7	4.2%
Development	66.1	5.2	7.9%	78.1	3.2	4.1%
<b>Total</b>	<b>465.5</b>	<b>41.7</b>	<b>9.0%</b>	<b>720.0</b>	<b>32.8</b>	<b>4.5%</b>

Historically the Group has pursued a strategy focusing on earnings growth whilst keeping within the strict confines of housing. Whilst good working capital management has been a cornerstone of the Group, equally cash has not been allowed to constrain the Group's operations. However, as the Group's housing business has evolved, it should be recognised that the different activities within Housing have significantly different working capital requirements.

Development representing 17% of divisional revenue in 2018 is a high volume and value activity. Given the requirement to maintain a high level of liquidity, it is a large number of applications, the housing cycle cannot be called or start cash calls. Accordingly, it is a key financial for a period of 90 days between completion of work and start of income through the averaging cycle to 70 days. On the positive, the measurement of revenue is low in value and there is no payment terms risk. The cost base includes specialist subcontractors and in-house supply with long payment terms averaging 42 days. As a result, typically around 30 days' work is advanced in working capital.

Management representing 18% of divisional revenue in 2018 is a lower volume and value activity. Given the operations being fixed to collecting and paying property rent. Typically low rental receipts and payments are paid monthly to a tenant such that the business operates on a low working capital requirement. Management representing 27% of divisional revenue in 2018 is based on low volume but high value transactions. These developments are being bid under a simple contracting relationship, work can be initiated during the course of construction although typically as projects approach their conclusion, the receipt income often. Some minor lease developments include work that is subject to private sale and lease back to the built cost of those units and their base. The direct costs are mainly subcontractors, long paid over 20 days from invoicing and as a result, this area of our housing activities can attract high levels of working capital.

The working capital allocation and volume of each activity are set out below:

	12 month average working capital	Annual working capital
Development	£m	£m
Management	28.0	75.0
Development	8.5	13.1
Management	11.1	13.6

\*This includes lease trade payables.

### Mears

Disclosure that explains differing working capital characteristics within underlying businesses.

Disclosures on the sources and uses of cash 29

**AstraZeneca**

**What is useful?**  
In their extracts, from the 2018 Annual Report, AstraZeneca highlight the importance of the supply chain financing program, its volume, and high level details of the working. They also provide links to further disclosure within other sections of the report with more detail.

**Supply chain financing**  
AstraZeneca has a supply chain financing programme to support their supply chain. This programme is supported by a partnership with Trade Finance and Capital Capital, provides suppliers with visibility of invoices and payment dates. Suppliers can access this facility to help manage their cash flow and to help them to manage their working capital requirements. Suppliers can also use this facility to help them to manage their working capital requirements. Suppliers can also use this facility to help them to manage their working capital requirements.

**Trade and other payables**  
The trade and other payables code provides control for the volume for financial years of operations and details that the group have assessed the nature of the balances and consider them to be correctly classified.

	2018	2017	2016
Trade payables	1,378	1,165	1,480
Other payables	1,000	1,100	1,100
Other payables (net of current tax liabilities)	4,558	4,558	4,558
Other payables (net of current tax liabilities)	5,936	6,823	7,138
Other payables (net of current tax liabilities)	94	100	100
Other payables (net of current tax liabilities)	607	520	527
Other payables (net of current tax liabilities)	617	520	527
Other payables (net of current tax liabilities)	18,881	17,041	16,466
Other payables (net of current tax liabilities)	3	101	201
Other payables (net of current tax liabilities)	3	101	201
Other payables (net of current tax liabilities)	4,228	4,228	4,228
Other payables (net of current tax liabilities)	1,308	1,308	1,308
Other payables (net of current tax liabilities)	1,308	1,308	1,308
Other payables (net of current tax liabilities)	4,719	4,840	4,840

The Group has reviewed the presentation of Trade and other payables in 2018 to separately present total trade payables and other revenue related trade payables, respectively, volume and other revenue related trade payables in 2018. The Group has also separately presented the AstraZeneca (and other) that has historically been presented within Other payables.

The Group has reviewed the presentation of Trade and other payables in 2018 to separately present total trade payables and other revenue related trade payables, respectively, volume and other revenue related trade payables in 2018. The Group has also separately presented the AstraZeneca (and other) that has historically been presented within Other payables.

Trade payables includes \$16m (2017: \$14m; 2016: \$16m) due to suppliers that have agreed to a supply chain financing programme, under which the suppliers can draw on a facility to receive their invoice before the partner bank other than being paid in line with the agreed payment terms. If the supplier takes the Group's facility it is assumed by the supplier to be due to the partner bank rather than the supplier. The trade and other payables include the trade payables that are subject to the supply chain financing programme. The trade payables that are subject to the supply chain financing programme are included in the trade payables that are subject to the supply chain financing programme. The trade payables that are subject to the supply chain financing programme are included in the trade payables that are subject to the supply chain financing programme.

### AstraZeneca

Disclosure that explains the group's approach to supplier financing.

## Cash generation within groups

Whilst investors are interested in the overall capacity of a group to generate cash they also want to understand where within the group the cash was generated, especially for credit investors. This is an area where there are limited examples of good disclosure in the market place but an area where investors need information. An example that provided insight was [Thames Water](#).

## An example focused on group and cash:

Disclosures on the sources and uses of cash 31

**Thames Water**

**What is useful?**  
Thames Water provides detail about how dividends and loan repayments flow through the various components of the group. This gives an understanding of the flow of cash and how it is used to fund operations and growth. The disclosure also identifies the dividends due to external shareholders until 2020/21, which gives a clear indication of how cash flows to the market.

**Annual Report and Annual Performance Report 2018/19**

**Dividends**  
During the year, we paid dividends of £60 million (2018: £150 million) to our immediate parent company, Thames Water Utilities Limited ("TWUL"), with all of the current year dividends being applied to servicing debt obligations and working capital requirements of other companies within the Thames Water Group.

No dividends were paid by the Thames Water Holdings Group to external shareholders for 2018/19 in line with our commitment to withhold paying or returning dividends until 2020/21. This commitment will continue to help us increase our equity buffer and broaden financial resilience, to improve our service to customers.

£ Equally, this is subject to the regulatory requirements set out in the regulatory code.

**Dividends**  
£21m  
£7bn  
£7bn  
£3m  
£60m  
£60m  
£60m

Dividends from other group company  
Thames Water Utilities Limited  
Thames Water Utilities Limited

Financing costs on external debt  
Working capital requirements  
Intra company loan interest

### Thames Water

Clear disclosure about the flow of interest and dividends through the group structure.

## Uses of cash

Investors want disclosures that:

**Provide detail on uses of cash both in the past and in the future.**

In [section 3](#) of the report we explore views on disclosures that provide information about uses of cash.

Once investors have considered how a company generates cash and the quality and sustainability of its generation, they then want to understand what a company intends to do with it. Investors use this information to help value the business, and also to support their consideration of the quality of management's stewardship.

Many investors and companies in this project felt that, in general, disclosure about the use of cash was good, both in annual reports or other communications such as investor presentations. However, investors would like more information that supports their own assessment of the likely future use of cash. Through our discussions, investors identified three areas for improvement:

- Disclosure that clarifies priorities for generated and available cash,
- Disclosure to allow assessment of the priorities in action, and
- Clearer explanations of how the priorities are impacted by relevant risks, restrictions and variabilities.

### Setting priorities for generated, and available cash

At its simplest level, capital allocation is a balance between maintaining and growing the business, and providing resources to other stakeholders.

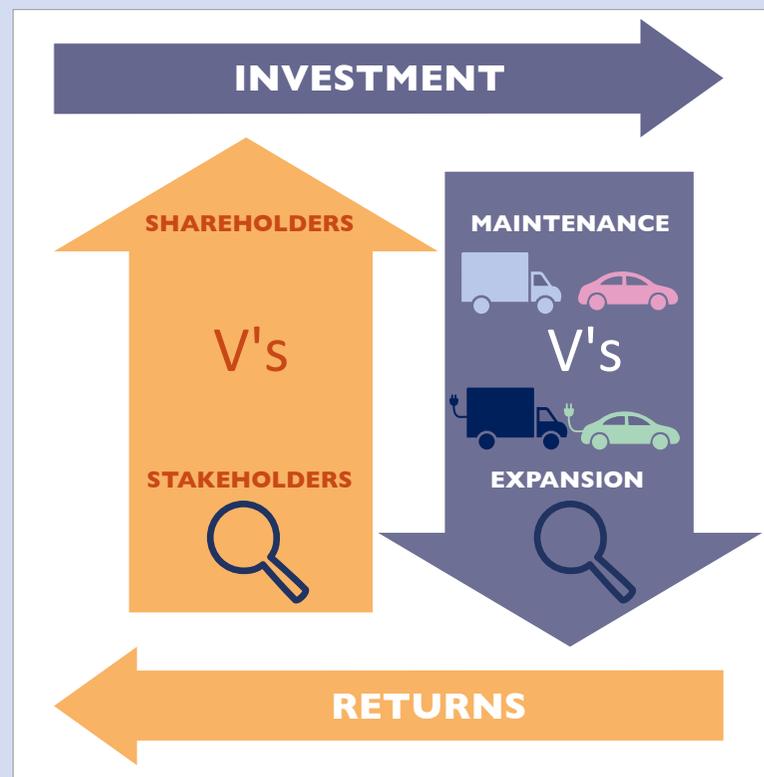
Differing considerations of the relative priorities will lead to a very different view for investors and stakeholders when assessing a company. That is why information about how companies prioritise different options and stakeholders is useful.

Many businesses have taken to creating more structured disclosures, often in the form of a capital allocation framework. This approach is particularly used by companies that are launching new or refreshed strategies.

Whilst often the disclosure of a framework provides only a high-level picture of a company's allocation priorities, it can serve to focus investor and management conversations on key aspects of the business. As such, investors often welcome such disclosure. Three examples of this are [Burberry](#), [Croda](#) and [IHG](#).

### Priorities in action

Once investors are clear about priorities, they then want more specific information on prioritisation in the period, and disclosures which help them to understand how current decisions might impact future flows. Detail regarding capital expenditure, dividends and other returns help establish whether management actions are aligned to these priorities. Examples of this are [AngloAmerican](#) and [Carnival Corporation](#).



## Variabilities, risks and restrictions

To evaluate properly the future potential returns from a business, investors need to be able to assess the upside opportunities and the downside risks. Investors understand that returns are variable and should reflect the changing focus and priorities of the company, the call of other stakeholders, and the availability of resources. Investors therefore value information that helps them understand the potential uncertainties and management's reaction. When thinking about the future availability of cash, that means they need information about:

- **Variability of future outcomes** – How does the company consider the range of possibilities for future cash use, and how does that help the prioritisation of decisions?
- **Risks** – What is the link between the risks facing the company and the outturn in cash generation, use, and dividend payment?
- **Restrictions** – Are there any restrictions on current or future cash, either through capital or exchange controls, availability of dividend resources or other items?

Examples of how this can be applied include [Chesnara](#), [Whitbread](#), [Drax](#), [RSA](#), [Phoenix Group](#), [AngloAmerican](#) and [Wizz](#).

## Examples which set the priorities include:

### Burberry and Croda

Clear capital allocation frameworks tied into the overall business model and strategy.

### IHG

A narrative approach to setting of priorities.

## Examples that cover the priorities in action and the risks and variabilities include:

### AngloAmerican

Clear capital expenditure information, with context.

### RSA

Disclosure that communicates the range and variability of future dividends.

### Wizz

Disclosure that highlights the relationship between restrictions and KPI's.

## Conclusion

Whilst this project has identified a number of areas where improvement in disclosure would be welcome, it is also clear that investors do not seek to overburden preparers. Many of the areas are relevant to investment decision-making and therefore, (where pertinent) they expect additional disclosure.

### How to read the full report

Using the model shown on page 3, the report provides more details about investor and preparer views on each topic and highlights relevant guidance and research. The report also includes a number of useful disclosures that were discussed with investors, sourced, both from the company participants in the project, and the wider market. In certain circumstances examples have been created by the Lab.

Given the breadth of the topic, each section stands alone and can be read as such. Those seeking a full understanding are advised to read the entire report.

## Examples used in the report

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## Introduction

The conceptual framework that underpins International Financial Reporting Standards (IFRS) states that:

*“The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.”*

[\(Para 1.3 – Conceptual Framework 2018\)](#)

Fundamental to the ability of those investors, lenders and other creditors to make decisions, is information about current and future anticipated cash resources. Cash is a core measure of business performance and position for both investors and companies themselves.

### The pre-eminence of the cash flow

The cash flow statement is important to investors (particularly smaller direct shareholders), and is considered (by users) to be less prone to management influence (especially accounting judgement) than the other primary statements. However, much research has been written which seeks to improve the cash flow statement and make it more representative of the underlying business activity. This includes work undertaken by the [FRC](#), [Chartered Financial Analyst Institute](#) and the [IASB](#), who have considered the position, and classification of different cash flows, differing approaches to creating cash flows (direct vs indirect) and other elements to better align the cash flow statement to a company’s operations.

However, does the cash flow tell the whole story? By its nature, the cash flow is a company’s aggregated and summarised historical information. This information is clearly useful for assessing management stewardship of assets but, is it enough for those potential investors, lenders and other creditors (mentioned in the conceptual framework) when they have a more forward-looking focus?

Our discussions with investors would suggest not completely. This report focuses on those additional disclosures that provide context and further information on the cash flows, to enable investors to assess the current position and future cash flows of the business.

### Answering investors’ questions

In this project, we have interviewed 15 investors on their needs on cash-related disclosure. Through our discussions, we have heard some core questions that investors wish to answer:

- How much cash is being generated from the operations of the business, both in the current period and future?
- Is generated cash likely to be sufficient to meet the company’s strategic objective and, if not, where will the required cash come from?
- What is the company planning to do with the cash it generates, especially beyond servicing its current operations?
- Is management being effective and efficient in its use of cash?

We have used these insights to develop a model of investor needs shown on page 11. This model is a basis to explore the topics of cash generation and use. The remainder of this report uses the model developed to consider investor and preparer perspectives, and highlights some examples of how this can be applied.

The report is split into three sections, focusing on drivers, disclosures focused on sources of cash, and disclosures focused on uses of cash.

## What investors want: Cash disclosures that

Provide a clear description of the drivers of current (and future) performance and position, in the context of cash, supported by appropriate metrics.

And further detailed disclosures on:

### The sources of cash

Which explain how the company's business model generates cash.

Which cover the drivers of performance that generated cash in the current period.

Which link to strategy, working capital and risks to allow an assessment of future cash generation.

### The uses of cash

Which explain a framework of priorities for the cash generated.

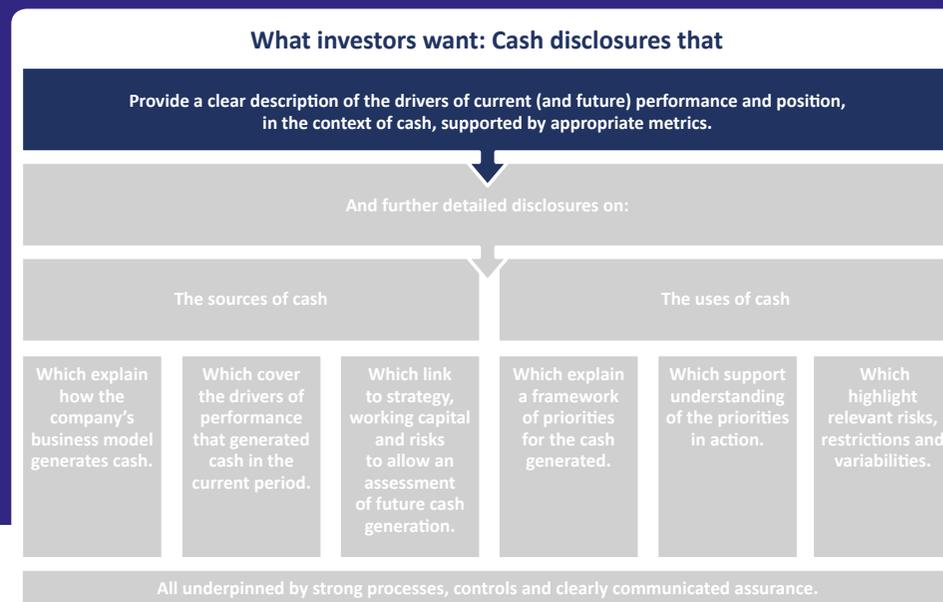
Which support understanding of the priorities in action.

Which highlight relevant risks, restrictions and variabilities.

All underpinned by strong processes, controls and clearly communicated assurance.

## Section 1

# Focus on drivers



## Focus on drivers

Investors want cash disclosures which:

**Provide a clear description of the drivers of current (and future) performance and position, in the context of cash, supported by appropriate metrics.**

Annual reports are a balance between backward-looking historical performance and forward-looking strategic elements. Investors' information needs are aligned to this. First, for those already invested, they want to assess the current year's performance and consider if the company can afford (in terms of cash, reserves and liquidity) the proposed dividend (the numbers). Second, for both current and potential investors, they want to understand how the company is positioned to perform in the future (the narrative).

Both the numbers and the narrative context are therefore important to investors; however, the most effective disclosures are those where numbers and narrative are combined in a way that shows how future performance is underpinned by the current results.

Companies agree; communicating their strategy and performance is an essential objective of their investor communications. However, for many companies, their primary focus is not on the historical cash flow statement, but other (often non-GAAP) measures of performance. This can often lead to a lack of direct, focused description of cash, its generation and use in the period.

Two ways in which we saw companies trying to communicate their cash position was through the selection and use of key performance metrics and through the use of narratives (that bring all the cash related elements together).

## Cash metrics disclosures

### Why cash metrics are important

At an underlying level, investors are focused on the long-term value creation of a business, and cash metrics are an essential part of that as they feed directly into valuation methodologies.

In the Lab's recent report [Performance Metrics – Principles and Practice](#) we heard from investors that a range of metrics (both GAAP and non-GAAP) are essential for understanding a company's position and performance. In this project, investors noted that cash related metrics are particularly important. Investors (and companies themselves) are interested in the stewardship of a company's assets (including cash resources), and how it grows those assets. Given this focus, it is not surprising that metrics which measure a company's ability to generate cash and efficiently use it, are important to both the managers of a business and to the investors who analyse them.

Approximately 60% of the FTSE 100 have a cash-related metric amongst their Key Performance Indicators (KPI's) with Net Debt being the most common and Free Cash flow being the second most common<sup>1</sup>. However there is also very limited consistency in the way that these metrics are calculated with many having their own methodology.

<sup>1</sup> Based on FRC Lab analysis of FTSE 100 companies as at 31 Dec 2018.

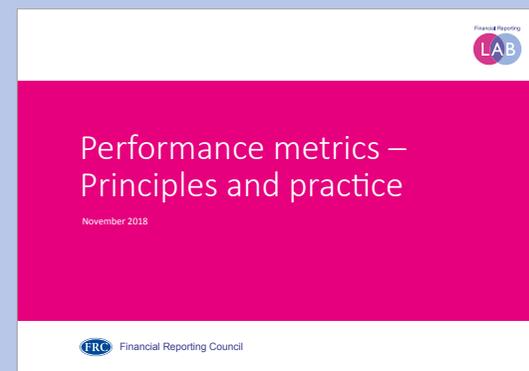
## Lab work

The Lab's work on performance metrics is available in two reports.

[Reporting on performance metrics – An investor perspective](#) which provides a framework for useful performance metric reporting, based on a series of interviews with 25 investors.

[Performance Metrics – Principles and Practice](#) which uses the framework from the first report to explore examples of useful disclosure and considers companies' perspectives and the wider regulatory context.

Both reports are available for free on the Lab's publications page on the FRC's website [www.frc.org.uk/lab](http://www.frc.org.uk/lab)



## What information is important?

Companies and investors in this project identified several key metrics and ratios that are important. These include:

Metrics that focus on the generation of cash, such as:

- Free-cash flow
- Cash conversion
- Operating cash flow

Metrics that focus on the availability of cash resource, such as:

- Net debt / Net cash
- Cash remitted to group

Metrics that focus on the use of cash, such as:

- Cash returned
- Capital expenditure

### What makes a useful disclosure?

Investors in the project echoed the core framework from the Lab's original performance metrics project, which detailed five principles. These can be applied to cash metrics as follows.

#### Principle 1

##### Aligned to strategy

The selected cash metrics should be appropriate to the company, its strategy, and the current business cycle. If a company is in a growth phase, the metrics may need to focus on capital expenditure or availability of cash. If it is in a stable period, then cash returns might be more appropriate. Investors note that relevance is more important than consistency, and if a company is transitioning from a growth to a stable period (or vice versa), it may be appropriate for companies to change or introduce new metrics when relevant and well explained.

#### Principle 2

##### Transparent

While overall cash metrics might seem like they should be the same from company to company, it is clear that they are not. Many companies (and investors) have their own ways that they present, define and use cash metrics. Therefore, as important as the provision of metrics themselves is the provision of sufficient granular detail to allow investors to calculate or adjust the metrics as they wish.

#### Principle 3

##### In context

Cash metrics should be put into context, by a narrative that explains how a company performed against the metrics and why, both when performance is positive and when it is negative. This also goes to credibility, an overt focus on positive metrics and limited discussion on negative metrics raises a red flag with users. One well-received way of providing context is through the use of KPI bridges (which graphically reconcile current and past years) supported by explanation.

#### Principle 4

##### Reliable

Where cash metrics are critical to the business, investors expect (rightly or wrongly) that they have been subjected to scrutiny from audit committees and auditors. There should be clear disclosure that explains the level of review for each metric. Where KPIs are provided within non-audited documents (such as presentations), investors expect that they should clearly relate or reconcile back to those in the audited documents, and that the links are clear and easy to follow.

#### Principle 5

##### Consistent

As previously noted, cash metric definitions are not often consistent across companies (especially in the case of free-cash flow). While most investors accept this (although some advocate standardised metrics), they do expect that year-on-year application of the metric will be consistent within a company. Where the company has made changes, they should explain why they have changed them, and provide historical comparatives. Investors are also skeptical of overly adjusted metrics which remove real cash outflows. As well as consistency over time, investors also expect that key cash metrics are used consistently across the full suite of reporting.

### Regulatory Focus

Investors also supported the guidance on Alternative Performance Measures (as issued by the European Securities and Market Authority) which sets out how APMs should be defined, presented and reconciled to GAAP measures.

[ESMA Guidelines on Alternative Performance Measures](#)

**2018/19 highlights****11.0p**

Proposed full-year dividend

**8.5%**

Return on capital employed

**22.0p**

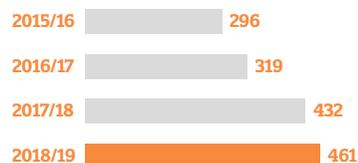
Underlying basic earnings per share

**£461m**

Free cash flow

**Retail free cash flow (£m)**

**Definition:** Net cash generated from retail operations, adjusted for exceptional pension contributions, after cash capital expenditure but before strategic capital expenditure and after investments in joint ventures and associates and Sainsbury's Bank capital injections

2014/15<sup>2</sup>**J Sainsbury plc****What is useful?**

In these extracts, Sainsbury's free cash flow KPI is disclosed in the narrative section of the annual report. The up-front focus is supported by a rationale and narrative context (not shown). Further support for the number is provided by way of a clear breakdown of its calculation in the audited financials. This allows investors to understand the use of the KPI and adjust the reported number if they wish to do so.

[J Sainsbury plc Annual Report 2019](#)

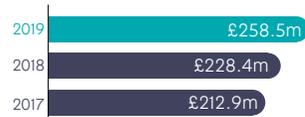
APM	Closest equivalent IFRS measure	Definition/Purpose	Reconciliation			
<b>Cash flows and net debt</b>						
<b>Cash flow items in Financial Review</b>	<b>No direct equivalent</b>	To help the reader understand cash flows of the business, a summarised cash flow statement is included within the Financial Review. As part of this a number of line items have been combined. The cash flow in note 4 of the financial statements includes a reference to show what has been combined in these line items.		Ref	2019 £m	2018 £m
			Net interest paid	a	<b>(89)</b>	(105)
			Strategic capital expenditure	b	<b>(36)</b>	(80)
			Acquisition of subsidiaries	c	–	135
			Repayment of borrowings	d	<b>(451)</b>	(174)
			Other	e	<b>(8)</b>	(2)
			Joint ventures	f	<b>13</b>	28
<b>Retail free cash flow</b>	<b>Net cash generated from operating activities</b>	Net cash generated from retail operations, adjusted for exceptional pension contributions, after cash capital expenditure but before strategic capital expenditure and after investments in joint ventures and associates and Sainsbury's Bank capital injections.  This measures cash generation, working capital efficiency and capital expenditure of the retail business.			2019 £m	2018 £m
			<b>Reconciliation of retail free cash flow</b>			
			Cash generated from retail operations		<b>1,156</b>	1,259
			Net interest paid (ref (a) above)		<b>(89)</b>	(105)
			Corporation tax		<b>(61)</b>	(72)
			Retail purchase of property, plant and equipment		<b>(470)</b>	(553)
			Retail purchase of intangible assets		<b>(78)</b>	(69)
			Retail proceeds from disposal of property, plant and equipment		<b>64</b>	54
			Add back: Strategic capital expenditure		<b>36</b>	80
			Dividends and distributions received		<b>18</b>	37
			Investment in joint ventures and associates		<b>(5)</b>	(9)
			Bank capital injections		<b>(110)</b>	(190)
			<b>Retail free cash flow</b>		<b>461</b>	432

## Cash generated from operations

£m

**£258.5m**

**+13%**



### Relevant focus areas

1 2 3 4 5 6

#### Definition

Cash generated from operations is as reported in the Consolidated statement of cash flows on page 87. This is defined as cash generated from operating activities, before corporation tax paid. This is considered to be a more meaningful measure of performance than the statutory measure of cash generated from operating activities, which can be distorted by changes in funding structure and the time lag that applies to the payment of corporation tax. Comparative periods have been restated to reflect the Group's adoption of the new accounting standard for Leases ('IFRS 16') from 1 April 2018 using the fully retrospective approach.

#### Progress

Cash generated from operations increased to £258.5 million in the year, giving growth of £30.1 million or 13%. This represented a high proportion of profit converted into cash, which was largely returned to shareholders through dividends and share buybacks.

### Relevant risks

1 2 3 4 5 6 7

### Linked to remuneration £

➤ Directors' remuneration report page 64

### Focus areas relevant to our KPIs

- 1 Maintain the best consumer experience for buying and selling vehicles
- 2 Create and maintain high-performing data-orientated teams
- 3 Grow ARPR in a balanced and sustainable way, by creating value for our customers
- 4 Improve stock choice, volumes, accuracy and transparency in both new and used vehicles
- 5 Develop a more efficient way for retailers to source, dispose and move vehicles
- 6 Extend our product offering further down the buying funnel, towards online transactions

➤ Our strategy pages 18-19

### Risks relevant to our KPIs

- 1 Economy, market and business environment
  - 2 Brand
  - 3 Increased competition
  - 4 Failure to innovate: disruptive technologies and changing consumer behaviours
  - 5 IT systems and cyber security
  - 6 Employee retention
  - 7 Reliance on third parties
- Principal risks and uncertainties pages 30-34



## What is useful?

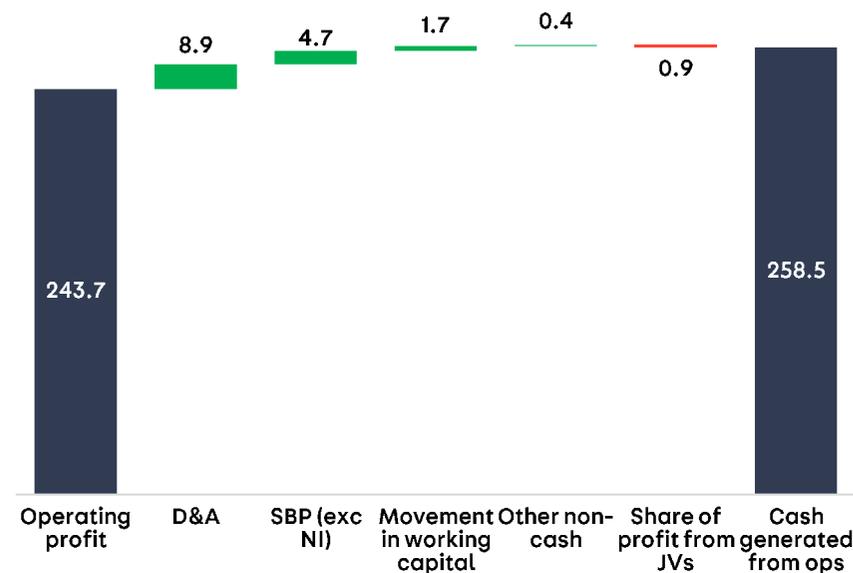
AutoTrader provides a clear definition of their KPI (cash generated from operations) and explain why they consider it useful. They also provide context by linking through to their strategic focus areas and risks, providing cross-references to other sections.

They provide a supporting bridge in the investor presentation showing how they go from operating profit to the KPI.

[AutoTrader Group plc Annual report 2019](#) and [Results presentation 2019](#)

## Cash generated from operations (£m)

Year ended 31 March 2019



## Bringing it all together

As with many topics of interest to investors, they are often confronted with a patchwork of relevant disclosures (in this case cash disclosure), both narrative and numerical, across multiple sections of the annual report and other investor-focused communications. The Lab’s recent [implementation study on Business models](#) identified a suite of disclosures that investors use to understand a company (see diagram below), and set out how these can be best linked together.

Many investors will review all the related disclosure to construct a picture of the company’s approach to cash generation and use. Others will focus on particular disclosures. As such, there is value to providing a hub for such disclosure, especially where cash (either the need for it, or the likely generation of it) is a vital aspect of the company’s investment case.

Companies are rightly concerned about disclosure becoming overly repetitive. However, this need not

be the case. As the Strategic Report guidance makes clear, the use of cross-referencing and sign-posting can assist in producing reports that work, both as a concise document, while also providing enough detail.

As part of the project, the Lab looked at several examples of reporting that attempted to provide a single central narrative. Those that were the most successful did not focus on cash in a standalone manner, but looked at cash as part of a more holistic discussion on performance and position.

Examples that are viewed positively by investors included the 4imprint example, which brings metrics, narrative and strategy together in a single page, and the Carnival Corporation narrative disclosure that provides high-level detail of cash movements. These examples can be found on the following pages.

### Regulatory requirements

There are a number of regulatory requirements that are important in the consideration of cash. Some of these requirements define how cash and capital can be used; others simply define aspects of disclosure.

The most important of these are the requirements embodied in the Companies Act (2006) which define when a dividend can be paid from a company. However the Companies Act has few detailed requirements for disclosures around cash (specifically). For those companies subject to the strategic report requirements it is the Strategic Report [supporting guidance](#) that provides clarification on how cash should be covered in business performance narrative.

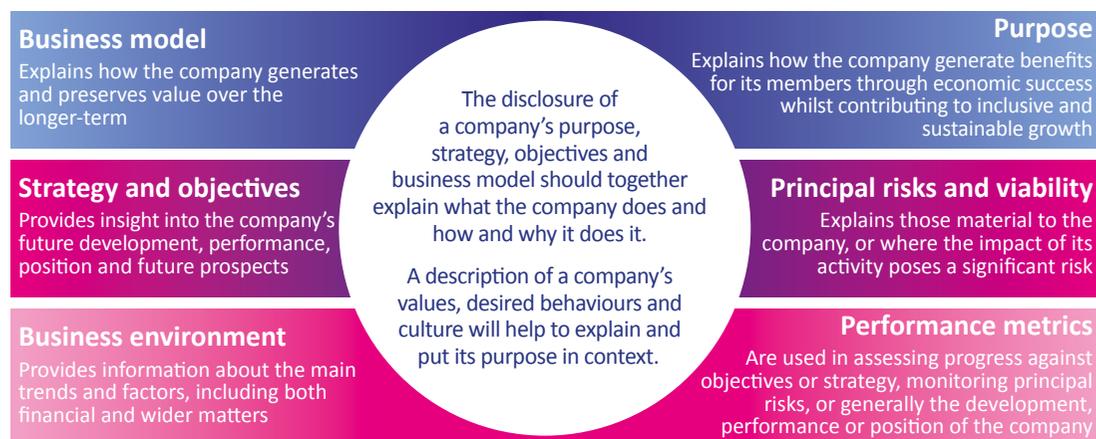
*“The strategic report must provide a fair, balanced and comprehensive analysis of the development of the business in the financial year and of its position at the end of the year” (7A.59)*

**It further clarifies:**

*“Where necessary for an understanding .... the analysis should make reference to cash flows during the year and factors that may affect future cash flows. Where appropriate, the strategic report should discuss the entity’s current and prospective liquidity and its ability to fund its stated strategy” (7A.62)*

Further requirements on disclosure come from the underlying accounting frameworks (IFRS etc.) and in the case of listed/quoted companies stem from other relevant legislation pertinent to one or multiple jurisdictions in which they are listed.

### The suite of disclosures that allow investors to understand a company:



## Objectives

### Cash generation and profitability

- To deliver reliable and increasing free cash flow over the medium to longer term
- To balance short-term profitability with marketing investment opportunities leading to sustainable long-term free cash flow and EPS growth

## Key enablers

- **Reinvestment of cash generated from operations into organic growth initiatives based on multi-year revenue/return projections**
- **Disciplined approach to investment:**
  - Marketing investment based on our assessment of both prevailing market conditions and a combination of current and future customer-centric metrics, including prospecting yield curves, retention patterns and lifetime revenue profiles
  - Capital investment evaluated based on cash payback and discounted cash flow parameters
- **Direct marketing 'drop-ship' business model, facilitating efficient working capital management**
- **Low capital intensity of the business**

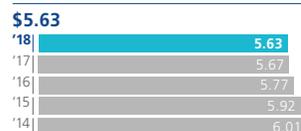
## Risks

- **Macroeconomic conditions**
- **Competition**
- **Currency exchange**
- **Business facility disruption**
- **Disruption to product supply chain or delivery service**
- **Disturbance in established marketing techniques**
- **Reliance on key personnel**
- **IT failure/interruption**
- **Security of customer data**

See pages 20–25.

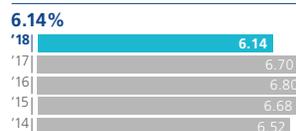
## KPIs

### Revenue per marketing dollar (\$)



Revenue per marketing dollar provides a measure of the productivity of our marketing investment. We measure performance relative to in-year targets as opposed to historical trend in accordance with our strategic objectives for organic growth, profitability and cash generation. The performance in 2018 should be set in the context of the investment during the year in brand marketing.

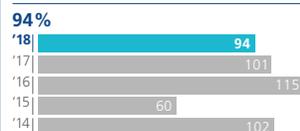
### Underlying\* operating margin (%)



This KPI shows the profitability of the Group's trading operations. In 2018 marketing investment in brand awareness impacted operating margin in the year. However, we believe that this investment will strengthen our position in the market allowing recovery in operating margin in subsequent years.

\* Underlying has been restated to include share option charges.

### Cash conversion (%)



Cash conversion measures the efficiency of the 4imprint business model in the conversion of operating profits into operating cash flow. 2018 was another strong year for cash conversion, reflecting good working capital management and the low fixed capital requirements of the business.



## What is useful?

4imprint brings several relevant cash disclosures together in a single page. They highlight how their objectives for cash relate to the key strategic drivers, and the risks that might impact those drivers. On the same page they also highlight the key performance indicators that, in their view, are relevant to assessing their performance against the objective.

Bringing everything together helps investors to quickly understand key elements of the company's story, but also provides links to more detail if they wish to dig deeper.

[4imprint Group plc Annual Report and Accounts 2018](#)



## Sources and Uses of Cash

### Operating Activities

Our business provided \$5.5 billion of net cash from operations during 2018, an increase of \$227 million, or 4.3%, compared to \$5.3 billion in 2017. This increase was driven by an increase in customer deposits. During 2017, our business provided \$5.3 billion of net cash from operations, an increase of \$188 million, or 3.7%, compared to \$5.1 billion in 2016. This increase was caused by an increase in our revenues less expenses settled in cash.

### Investing Activities

During 2018, net cash used in investing activities was \$3.5 billion. This was caused by:

- Capital expenditures of \$2.1 billion for our ongoing new shipbuilding program
- Capital expenditures of \$1.7 billion for ship improvements and replacements, information technology and buildings and improvements
- Proceeds from sale of ships of \$389 million
- Purchase of minority interest of \$135 million
- Payments of \$39 million of fuel derivative settlements

During 2017, net cash used in investing activities was \$3.1 billion. This was caused by:

- Capital expenditures of \$1.4 billion for our ongoing new shipbuilding program
- Capital expenditures of \$1.5 billion for ship improvements and replacements, information technology and buildings and improvements
- Payments of \$203 million of fuel derivative settlements

During 2016, net cash used in investing activities was \$3.3 billion. This was caused by:

- Capital expenditures of \$1.9 billion for our ongoing new shipbuilding program
- Capital expenditures of \$1.2 billion for ship improvements and replacements, information technology and buildings and improvements
- Payments of \$291 million of fuel derivative settlements
- Proceeds from sale of ships of \$26 million

## What is useful?

Carnival provides a high-level narrative on key aspects of the sources and uses of cash for the current, and prior two years. This allows investors to get a quick sense of performance and position and identify areas for further review.

[Carnival Corporation & PLC Annual Report 2018](#)

### Financing Activities

During 2018, net cash used in financing activities of \$1.5 billion was substantially all due to the following:

- Net proceeds of short-term borrowings of \$417 million in connection with our availability of, and needs for, cash at various times throughout the period
- Repayments of \$1.6 billion of long-term debt
- Issuances of \$2.5 billion of long-term debt
- Payments of cash dividends of \$1.4 billion
- Purchases of \$1.5 billion of Carnival Corporation common stock and Carnival plc ordinary shares in open market transactions under our Repurchase Program

During 2017, net cash used in financing activities of \$2.5 billion was substantially all due to the following:

- Net repayments of short-term borrowings of \$29 million in connection with our availability of, and needs for, cash at various times throughout the period
- Repayments of \$1.2 billion of long-term debt
- Issuances of \$100 million of long-term debt under a term loan
- Proceeds of \$367 million of long-term debt under an export credit facility
- Payments of cash dividends of \$1.1 billion
- Purchases of \$552 million of Carnival Corporation common stock and Carnival plc ordinary shares in open market transactions under our Repurchase Program

During 2016, net cash used in financing activities of \$2.6 billion was substantially all due to the following:

- Net proceeds from short-term borrowings of \$447 million in connection with our availability of, and needs for, cash at various times throughout the period
- Repayments of \$1.3 billion of long-term debt
- Issuances of \$555 million of euro-denominated publicly-traded notes, which net proceeds were used for general corporate purposes
- Proceeds of \$987 million of long-term debt
- Payments of cash dividends of \$977 million
- Purchases of \$2.3 billion of shares of Carnival Corporation common stock and \$35 million of Carnival plc ordinary shares in open market transactions under our Repurchase Program

## Section 2

# Disclosures supporting the sources of cash



## Where is the cash coming from?

Investors want cash disclosures that:

**Provide details about sources of cash both now, and in the future.**

### Explaining how a business generates cash

Understanding the link between the operations of a company and its generation of cash is important for investors. However, it is something that is not always easy to do from the information a company discloses in the annual report.

The Lab's recent implementation study on business model reporting ([Business model reporting, Risk & Viability reporting – Where are we know?](#)) showed that many companies are failing to answer basic questions with their disclosures, such as how a business actually makes money.

Investors who participated in this project noted that this lack of clarity is still prevalent; it can be challenging to understand how businesses' operations are generating cash.

Whilst the business model disclosure is not the only place investors will go for information, for many it remains an important first port-of-call, especially for those new to the business. As such, it is important that the disclosure either clearly explains how and where cash is generated, or references relevant disclosure throughout the rest of the report.

### Balancing simplicity and complexity

Many preparers try to keep the business model disclosure relatively high-level. However, investors would appreciate more detail, either directly or linked to the business model disclosure.

Key aspects of cash generation that could be enhanced in business model, and related disclosures include:

- Disaggregation of profit generation, by product line, segment or geography (whichever is most relevant), and
- Detail about the conversion of profit into free cash or other cash metric, as selected by the company.

### Disaggregation

Providing some high-level indication of the elements of the business that are generating profit and cash help investors focus their attention on what is important. Providing detail in the business model that helps them to understand the split of cash and profit is helpful. Details can be relatively focused (e.g. cash or revenue as a %), but ideally would link to fuller disclosure within the rest of the report. Where the business model is undergoing change and the disclosure for the period is not representative of the group, or its likely ability to generate cash/profit going forward, highlighting this is also important.

### Providing a little more

Where a company operates multiple businesses with different cash generating characteristics, additional narrative and numerical breakdowns are helpful, and some investors would like to see a cash flow and key cash metrics for each part of the business. Ideally, this

breakdown would be within the annual report (and thereby subject to a certain level of assurance), but some are happy for it to be within the investor presentation or other communications, as long as it is clear how it ties back to audited material. While some preparers highlighted that, specifically for cash KPIs, many of the KPIs do not make sense at a segment or business level (particularly the case where the group may pool or manage cash centrally), investors consider that a short explanation as to the rationale for the level of disclosure is still of value.

In the following pages we highlight some examples of high-level business model disclosures that focus on cash generation and disaggregation at segment level.

### When cash needed is dependent on financing

Over the longer-term companies are only viable if they can generate sustainable positive cash flows from the underlying business. However, investors understand that over the short or medium-term companies might need additional financing to fund restructuring or expansion. Where companies need to raise financing or are dependent on the renegotiation of existing finance, investors expect that this is acknowledged and disclosed. The Lab's previous report on [Debt terms and maturity tables](#) highlighted some of the items that were useful for investors in assessing a company's current debt (such as maturity, cost etc.) and our report on [Risk and viability reporting](#) highlighted the importance of appropriately linking financing issues in both the risk and viability statements, especially where any renegotiation is likely to occur during the viability period selected.



## BUSINESS MODEL HOW WE CREATE VALUE

OUR STRATEGIC PRIORITIES HELP ENHANCE THE VALUE WE CREATE THROUGH OUR BUSINESS MODEL.

### 01 IMPROVE CUSTOMER OUTCOMES

Improving customer outcomes is central to our vision of being Europe's Leading Life Consolidator, and to inspire confidence in the future.

Read more on P18

### 02 DRIVE VALUE

In order to drive value, the Group looks to identify and undertake management actions, which increase and accelerate cash flow.

Read more on P22

### 03 MANAGE CAPITAL

We continue to focus on the effective management of our risks and the efficient allocation of capital against those risks.

Read more on P24

### 04 ENGAGE COLLEAGUES

Our people are at the heart of our business and key to the successful growth of Phoenix Group.

Read more on P26

## OUR CASH GENERATION HELPS US REALISE OPPORTUNITIES FOR GROWTH

### IN-FORCE BOOK CASH EMERGENCE

Capital requirements of operating life companies decline as policies mature, releasing capital in the form of cash

### MANAGEMENT ACTIONS

Management track record of delivering incremental value

### NEW BUSINESS

Capital-light new business under the Strategic Partnership with Standard Life Aberdeen and vesting annuities from our Heritage business

### MERGERS AND ACQUISITIONS

Value accretive acquisitions generate increased cash flows and synergy opportunities through scale advantages

### BULK PURCHASE ANNUITY TRANSACTIONS

The bulk purchase annuity market offers a complementary source of assets and growth

## RESULTING OUTCOMES DELIVERED ARE POSITIVE FOR ALL STAKEHOLDERS

### CUSTOMERS

Optimised customer outcomes

Read more on P48

93%

CUSTOMER SATISFACTION

REM

### SHAREHOLDERS

Shareholder value created and stable and sustainable dividends delivered

Read more on P58

£664m

CASH GENERATION

APM

3.5%

INCREASE IN 2018 FINAL DIVIDEND

### COLLEAGUES

Challenged, motivated and rewarded colleagues

Read more on P51

### COMMUNITY & ENVIRONMENT

Support for local communities and charity partners and reduced environmental impact

Read more on P54

£770k

DONATED TO MIDLANDS AND LONDON AIR AMBULANCE CHARITY PARTNERS



Read more about our cash generation on P16

STRATEGIC REPORT  
CORPORATE GOVERNANCE  
FINANCIALS  
ADDITIONAL INFORMATION

**What is useful?**

Phoenix has a series of disclosures in and around the business model that provide some additional insight into cash generation.

The business model focuses on the importance of cash generation to the business, and how that links to opportunities for growth, and ultimately stakeholder returns.

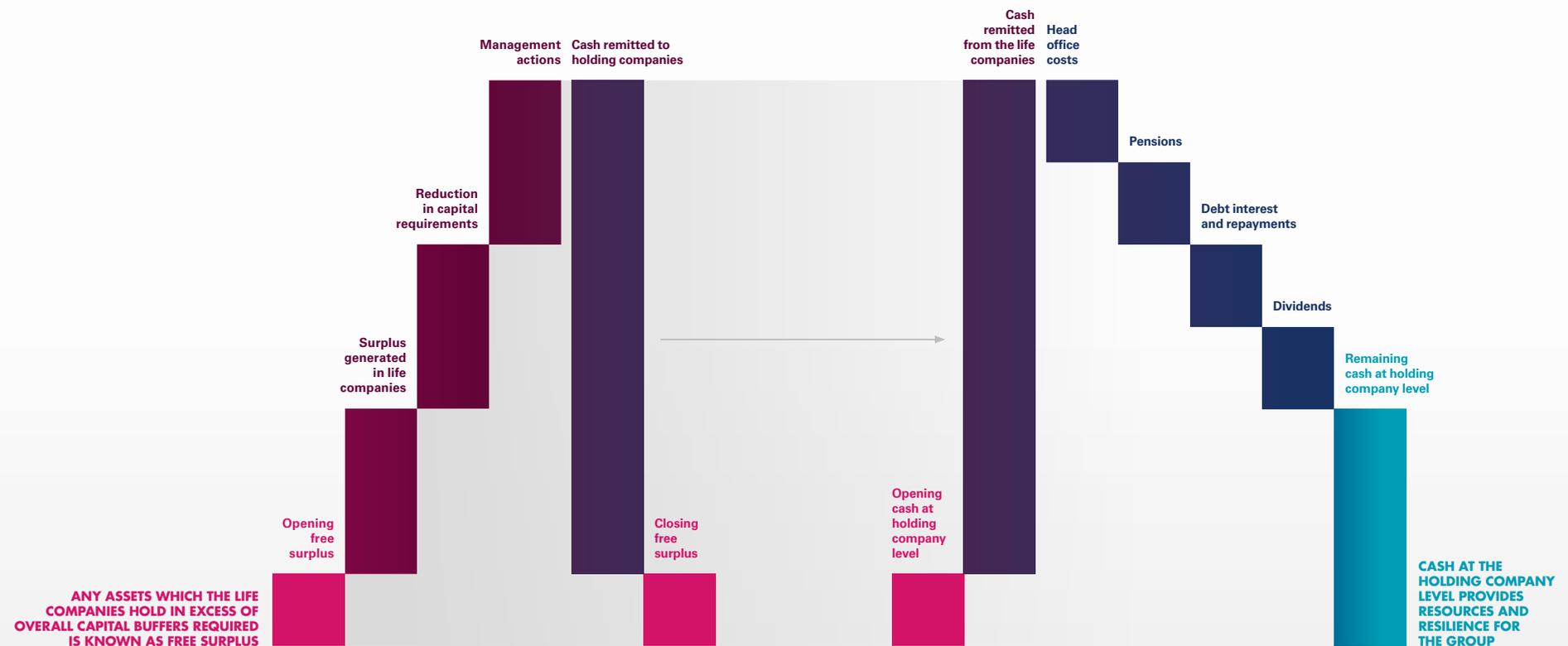
Given that life insurance is a relatively complex business, they also provide a simplified yet engaging illustrative explanation of the source and use of cash within life insurance companies.

[Phoenix Group Annual Report 2018](#)

see next page



**BUSINESS MODEL CONTINUED**  
OUR CASH GENERATION PROCESS



\* For illustrative purposes only.

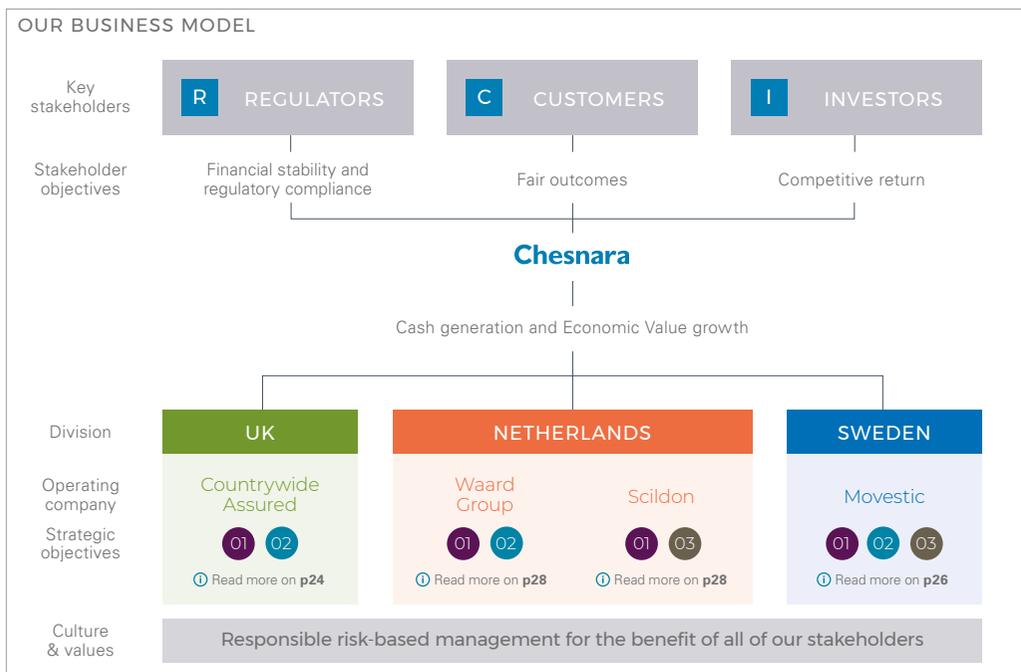
**OPENING FREE SURPLUS**

**SOURCES OF LIFE COMPANY CASH GENERATION**

**USES OF HOLDING COMPANY CASH GENERATION**

**USES OF REMAINING CASH – GROWTH OPPORTUNITIES**

- STRATEGIC REPORT
- CORPORATE GOVERNANCE
- FINANCIALS
- ADDITIONAL INFORMATION



**What is useful?**

Chesnara uses a simple business model to note the cash generation relationship between the underlying divisions and the group centre, with helpful cross references to further information. This high-level disclosure is further supported by a more detailed narrative and a roll forward of cash generation at a divisional level.

[Chesnara Annual Report and Accounts 2018](#)

**FINANCIAL REVIEW • CASH GENERATION**

**GROUP CASH GENERATION**  
**£47.8m** 2017: £28.6m

**DIVISIONAL CASH GENERATION**  
**£63.9m** 2017: £86.7m

Significant cash generation in the UK has driven a total divisional cash result of £63.9m for the year, with supporting contributions from Movestic and Waard. Cash is generated from increases in the group's solvency surplus, which is represented by the excess of assets held over management's internal capital needs. These are based on regulatory capital requirements, with the inclusion of additional 'management buffers'.

**GROUP**

- Sufficient group cash has been generated in the year to cover the cost of last year's dividend.
- The overall increase in group cash year on year is a factor of several material items. The 2017 result includes the impact of the completion of the Legal & General Nederland (Scildon) acquisition which, in line with expectations, resulted in a £55.3m negative impact on cash generation. A £26.8m release from the with-profit funds has driven a sizeable increase in UK cash in 2018. In the opposite direction there has been a £34m adverse year on year movement in Scildon's cash generation. Much of the movement is due to the fact that economic conditions had a positive impact on Own Funds in 2017 whereas in 2018 falling bond values resulted in Own Funds losses of over £20m. A strengthening of mortality assumptions also had an adverse impact in 2018.
- Other group activities reflect group expenses and the impact of consolidation routines, specifically movements in capital requirements determined at a group level. From a capital requirement perspective, this is driven by movements in required capital at a Chesnara holding company level coupled with consolidation adjustments. At a Chesnara holding company level, additional capital is principally required to be held for the currency risk associated with the Movestic, Scildon and Waard Group surplus assets.

2018 £m	Movement in Own Funds	Movement in management's capital requirement	Forex impact	Cash generated	2017 £m	Cash generated
UK	18.0	37.8	-	55.8	34.5	34.5
Sweden	(10.7)	30.1	(1.3)	18.1	24.9	24.9
Netherlands – Waard Group	3.0	4.6	0.2	7.8	11.1	11.1
Scildon	(23.5)	6.2	(0.4)	(17.8)	16.2	16.2
<b>Divisional cash generation</b>	<b>(13.2)</b>	<b>78.6</b>	<b>(1.4)</b>	<b>63.9</b>	<b>86.7</b>	<b>86.7</b>
Other group activities	(13.6)	(3.6)	1.0	(16.1)	(2.7)	(2.7)
Impact of LGN acquisition	-	-	-	-	(55.3)	(55.3)
<b>Group cash generation</b>	<b>(26.8)</b>	<b>75.0</b>	<b>(0.4)</b>	<b>47.8</b>	<b>28.6</b>	<b>28.6</b>

## Interaction with regulation

Both the examples on cash generation from the previous pages are from companies within the insurance industry, and in this case specifically the life insurance segment. Throughout this report you will find examples from the insurance and utilities' sectors. Due to their very long time horizons, and the complex interaction between shareholder returns and prudent protection of the wider stakeholders/policyholder interest, the regulators of these industries have focused companies on the protection of capital. This has led to a general focus within these companies (and therefore their investors) on unencumbered cash generation.

Many of the disclosures we highlight are derived from (or work alongside) the regulatory reporting requirements of their industry regulator. Nevertheless they represent some of the more interesting cash generation (and use) disclosures currently in the market. Whilst they may be more than many companies need, such disclosures were well received by a wide range of investors (many of whom focus on other industries). We therefore consider them useful examples to demonstrate attributes valued by investors.



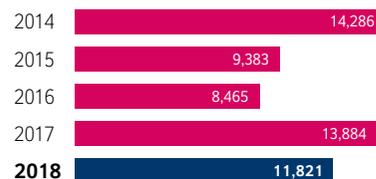
## Cash generation – forward guidance

While companies are concerned about providing forward guidance (especially those with US listings) for many, understanding where cash will be generated from in the future is a key element of their investment story. Therefore providing some disclosure that covers this is very useful.

Investors consider that companies could do more; for investors, there is a distinction between narrative that provides broad indications and detailed specific forecasts. While they would value detailed guidance, a more high-level directional narrative that may focus on trends and policies, for example, is still helpful and perhaps more in line with companies' comfort level. Ideally investors would like this disclosure integrated throughout the annual report, from business model to strategy to viability. However, investors recognise that companies might be more comfortable providing this within presentations such as those supporting the annual results or capital markets' days.

### Net cash generated from operating activities<sup>3</sup>

\$ millions



#### Definition

Cash generated by our operations after tax and interest, including dividends received from equity accounted units and dividends paid to non-controlling interests in subsidiaries.

#### Performance

Net cash generated from operating activities of \$11.8 billion was 15% lower this year, primarily due to higher tax payments related to 2017 profits and adverse working capital movements.

#### Relevance to strategy

This KPI measures our ability to convert underlying earnings into cash.

#### Associated risks

- Market risks, such as variability in commodity prices and exchange rates.
- Operations, projects and people risks, including improvements in productivity.
- Stakeholder risks, including the actions of joint-venture partners, third parties and governments.

#### Link to executive remuneration

Included in the short term incentive plan; in the longer term, the measure influences TSR which is included in long term incentive plans (see pages 108 and 109).

#### Forward plan

We aim to generate additional free cash flow from our five-year productivity programme (2017 to 2021). We expect the programme to deliver at least an additional \$1.5 billion of incremental cash flow from 2021, and in each year thereafter.

## What is useful?

Rio Tinto provides the historical context for net cash generation as well as highlighting how it feeds into executive remuneration targets. By also providing detail on associated risks, as well as the company's forward plan, they provide some forward direction.

[Rio Tinto Plc Annual Report 2018](#)

## Connecting cash and working capital

As well as understanding how companies generate cash, to fully understand the health of a business, investors also need to understand a company's approach to working capital. Without sufficient and well controlled working capital, a company will struggle to balance growth, liquidity and solvency.

### What questions are investors looking to answer?

In the previous section we saw that investors want to understand how a business model generates cash, but cash is only part of the story. The importance of the interaction between profit, cash, trade debtors and trade creditors are areas where investors want more information.

Investors participating in this project noted that they seek disclosures that help them understand the particular company and its relationships so that they can better model its future value. They also want to understand how changes in those relationships flow through to the business, allowing them to better appreciate current performance and future risks.

### What information is important?

Disclosures that help investors understand standard approaches to working capital are:

- Information about trade debtors, such as debtor days,
- Information about trade creditors, such as creditor days,
- Information about inventory such as inventory days, and
- Information about working capital management practices.

Like many of the areas that investors identify, their expectations for the level of focus and detail in these disclosures is dependent on the industry and the company's position in the economic cycle.

### What information is missing?

Overall, investors did not identify working capital disclosures as a particular issue. However, areas where investors did have more concern were:

- Where businesses within a single company had very different working capital requirements or approaches,
- Where changes to working capital processes were driving overall cash generation, and
- Where a specific approach to financing, such as factoring or reverse factoring needed to be understood to properly comprehend the company's approach to working capital (see box).

Investors considered that these were often areas where companies' disclosures were not fulsome, were opaque, or were not evident at all.

Whilst preparers are rightly concerned about the creation of overly onerous or detailed disclosure, they do appreciate that giving more disclosure (especially when a business or its approach is evolving) would enhance investor understanding.

The rest of this section provides examples from the project that investors found useful in highlighting an aspect of the above.

## Reverse factoring and payment practice

When the project began, it was not considered that working capital facilities such as factoring, reverse factoring or supplier chain finance would be a significant area of focus. However, a number of the investors that we interviewed raised specific concerns about the quality of disclosure in these areas. This report includes an example of good disclosure from AstraZeneca plc (page 29). However, many investors raised concerns that those making the most use of these types of facilities were less forthcoming. To assist in moving forward, the Lab has created an example that meets many investors' needs in this area. Alongside the example disclosure, Appendix A provides further discussion and explanation about the nature and prevalence of reverse factoring.

As the project was concluding, the Department for Business Energy and Industrial Strategy, released a paper on [Creating a responsible payment culture](#)

This paper (amongst other aspects) explained that the Government would work with the FRC to develop guidance on disclosure around supply chain financing.

# MEARS

## What is useful?

In this extract Mears provides a narrative description of how different parts of the Housing division operates and support this with numeric disclosure. This helps investors understand the dynamics of the business better and provides a bridge between the group's overall strategic intentions and what it means for individual components of the business.

[Annual Report and Annual Performance Report, 2017/18](#)

Historically the Group has pursued a strategy focusing on earnings growth whilst keeping within the strict confines of Housing. Whilst good working capital management has been a cornerstone of the Group, equally cash has not been allowed to constrain the Group's evolution. However, as the Group's Housing business has evolved, it should be recognised that the different activities within Housing have significantly different working capital requirements:

~ Maintenance (representing 77% of divisional revenue in 2018) is a high volume and low value activity. Given the requirement to measure, review, inspect and value a large number of works orders, the invoicing cycle cannot be rushed or short cuts taken. Accordingly, it is not unusual for a period of 90 days between completion of work and receipt of income although the average is closer to 70 days. On the positive, the measurement of revenues is very secure and there is minimal bad debt risk. The cost base includes specialist subcontractors and merchant suppliers with varying payment terms averaging 40 days. As a result, typically around 30 days' work is absorbed in working capital.

	2018			2017		
	Revenue £m	Operating profit £m	Margin %	Revenue £m	Operating profit £m	Margin %
Maintenance	578.7	28.0	4.8%	606.2	32.6	5.4%
Management	135.4	8.5	6.3%	133.8	5.7	4.3%
Development	39.1	1.1	2.8%	26.1	1.2	4.6%
Total	753.2	37.6	5.0%	766.1	39.5	5.2%

~ Management (representing 18% of divisional revenue in 2018) is lower volume with the most significant transactions being linked to collecting and paying property rentals. Typically both rental receipts and payments are paid monthly in arrears such that the business operates on a low working capital requirement.

~ Development (representing 5% of divisional revenue in 2018) is based on low volume but high value transactions. Where developments are being built under

a simple contracting relationship, work can be invoiced during the course of construction although typically as projects approach their conclusion, the receipts become slower. Some mixed tenure developments include units that are subject to private sale and Mears funds the build cost of those units until their sale. The direct works are entirely subcontracted, being paid in around 30 days from invoicing and as a result, this area of our Housing activities can absorb high levels of working capital.

The working capital allocation and returns of each activity are set out below:

	Operating profit £m	12-month average working capital £m	Return on working capital employed*
Maintenance	28.0	19.0	>100%
Management	8.5	1.7	>100%
Development	1.1	15.6	7%

\*Trade receivables less trade payables.



## Free cash flow impacted by working capital

### Free cash flow (£m)

Half year ended 30th September	2018	2017
Underlying operating profit	271	250
Depreciation and amortisation <sup>1</sup>	79	77
Precious metal working capital outflow	(283)	(156)
Non precious metal working capital outflow	(76)	(91)
Other working capital outflow	(32)	(17)
Net working capital outflow <sup>2</sup>	(391)	(264)
Net interest paid	(23)	(19)
Tax paid	(48)	(45)
Capex spend	(96)	(81)
Other	2	(8)
<b>Free cash flow</b>	<b>(206)</b>	<b>(90)</b>



1. Excluding amortisation of acquired intangibles and restructuring impairments
2. Includes movements in provisions

### What is useful?

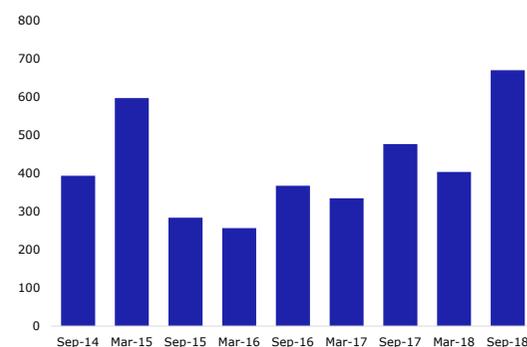
In this extract from their investor presentation, Johnson Matthey breaks down the impact that working capital has had, by segment, on free cash flow. They then provide further detail for each segment.

[Half Year Investor Presentation 2018](#)



### Pgm refinery downtime impacted precious metal working capital

#### Precious metal (pm) working capital (£m)



Pm working capital increased £267 million<sup>1</sup>, mainly in pm inventory

Impact from pgm refinery downtime

- Expect a significant reduction in pm working capital by year end

## What is useful?

In these extracts, from the [2018 Annual Report](#), AstraZeneca highlights the existence of the supply chain financing program, its rationale, and high-level details of its working. They also provide links to further disclosure within other sections of the report with more detail.



### Supply chain financing

AstraZeneca has a supply chain finance programme to support the cash flow of its supply base. This programme, in partnership with Taulia Inc. and Greensill Capital, provides suppliers with visibility of invoices and payment dates. Suppliers can access this platform free of charge and have full optionality and flexibility on an invoice by invoice basis to request early payment of invoices. On election of an early payment, a charge is incurred by the supplier based on the period of acceleration, central bank interest rate, and the rate agreed between Taulia Inc. and each supplier. All early payments are paid by Greensill Capital, and AstraZeneca settles the original invoice amount with Greensill Capital at maturity of the original invoice due date.

We believe this programme offers a benefit to our suppliers, as it provides visibility and flexibility to manage their cash flow, and the rates offered can be preferential to their cost of funding. The programme is currently live in the US, UK, Sweden and Germany. As of December 2018, the programme had 2,548 suppliers enrolled, and a potential early payment balance of \$166 million.

 For more information on supply chain financing, see Note 19 on page 177.

## What is useful?

The trade and other payables note provides context for the scheme by showing two years of comparatives, and clarifies that the group have assessed the nature of the balances, and considers them to be correctly classified.



### 19 Trade and other payables

	2018 \$m	2017 \$m	2016 \$m
<b>Current liabilities</b>			
Trade payables	1,720	2,285	1,680
Value added and payroll taxes and social security	204	243	240
Rebates, chargebacks, returns and other revenue accruals	4,043	3,264	3,601
Clinical trial accruals	993	922	696
Other accruals	3,951	3,324	2,714
Externalisation revenue contract liabilities	92	–	–
Contingent consideration	867	555	527
Other payables	971	1,048	1,028
<b>Total</b>	<b>12,841</b>	<b>11,641</b>	<b>10,486</b>
<b>Non-current liabilities</b>			
Accruals	7	143	292
Externalisation revenue contract liabilities	78	–	–
Contingent consideration	4,239	4,979	4,930
Acerta Pharma put option liability (Note 25)	1,838	1,823	1,901
Other payables	608	895	2,365
<b>Total</b>	<b>6,770</b>	<b>7,840</b>	<b>9,488</b>

The Group has revised the presentation of Trade and other payables in 2018 to separately present clinical trial accruals, returns and other revenue accruals that have historically been presented within Trade payables (see the Group Accounting policies section from page 153). The Group has also separately presented the Acerta put option that has historically been presented within Other payables.

Included within Rebates, chargebacks, returns and other revenue accruals are contract liabilities of \$126m (1 January 2018: \$138m). The revenue recognised in the year for contract liabilities is \$139m, comprising \$104m relating to other revenue accruals and \$35m Externalisation Revenue contract liabilities.

Trade payables includes \$166m (2017: \$64m; 2016: \$nil) due to suppliers that have signed up to a supply chain financing programme, under which the suppliers can elect on a invoice by invoice basis to receive a discounted early payment from the partner bank rather than being paid in line with the agreed payment terms. If the option is taken the Group's liability is assigned by the supplier to be due to the partner bank rather than the supplier. The value of the liability payable by the Group remains unchanged. The Group assesses the arrangement against indicators to assess if debts which vendors have sold to the funder under the supplier financing scheme continue to meet the definition of trade payables or should be classified as borrowings. At 31 December 2018 the payables met the criteria of Trade payables.

## Cash generation within groups

Investors are interested in the overall capacity of a group to generate cash, but also want to understand where within the group the cash was generated, especially for credit investors. This understanding is particularly important where a group contains operations that are subject to capital management restrictions, either due to location, regulation, or other hard or soft impediments (such as joint venture structures or pension obligations).

The nature of any such restrictions or impediments might also mean that there is wider stakeholder interest outside of the traditional investor community, such as regulators, pensioners or the wider public. Some companies answer these disclosure needs through the annual report; others publish specific documents that provide an overview of their financing and how this translates into the flow of returns (see box) or hold debt focused investor days.

*“It is not just good enough for me to know how much is generated, where it is generated makes a big difference to my assessment”*

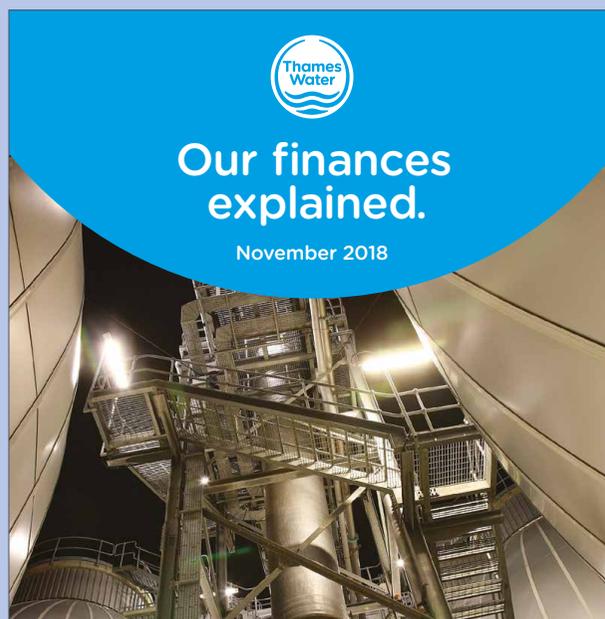
**Investor**

### Providing stakeholders with clarity

Thames Water is one company that provides stakeholders with an overview of its funding and returns.

The document is primarily aimed at customers and wider stakeholders, but they also receive positive feedback from investors.

They have produced a separate stakeholder-focused summary of key financing information [Our finances explained](#), since 2014. They started producing the supplement after receiving press and public focus on their corporate structure.

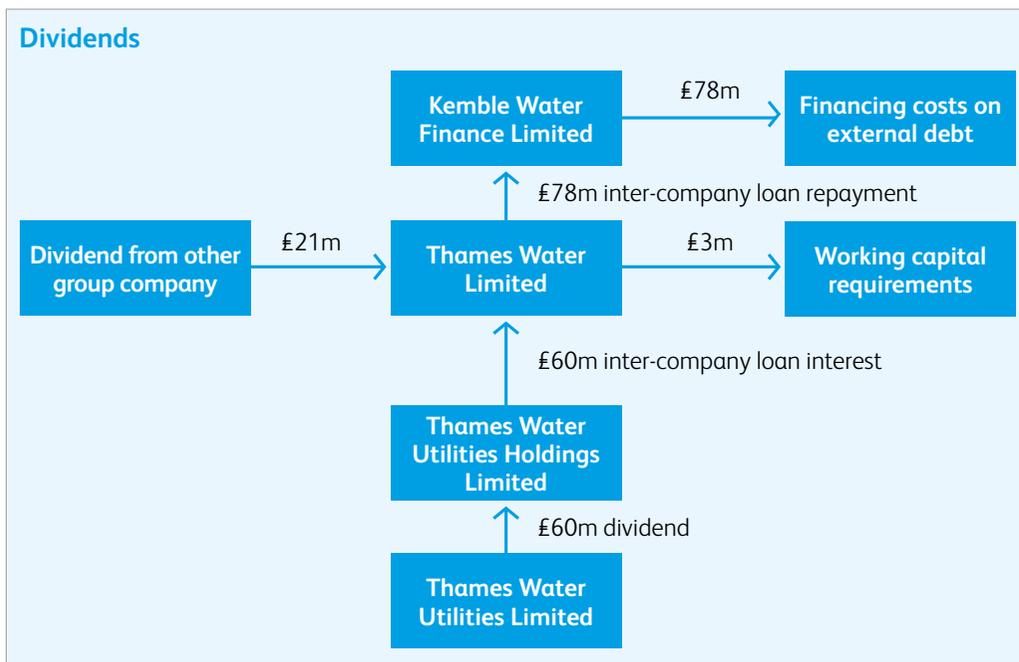


### Group vs entity

The Lab’s early work on dividend disclosure showed that there is often limited disclosure about the generation of cash at the holding company level, not least because most of the FTSE 100 opt not to present a holding company Income Statement.

Because many investors are ultimately interested in returns via dividends, information about the sources of the holding company’s dividend resources is crucial to investors. This is especially the case where there is a different nature to the income/cash that is supplying the holding company than that being generated at a subsidiary level (eg. operating income versus investment income).

Dividends are covered in more detail in the use of cash section of this report. However, this section includes an example that provides investors with clarification of how generated cash moves from the operating business to the holding company.



**What is useful?**

Thames Water provides detail about how dividends and loan repayments flow through the various key components of the group understanding of how the business is using cash for debt repayment and returns. The disclosure also clarifies that no dividend is due to external shareholders until 2020/21, which gives users some indication of flows into the future.

[Annual Report and Annual Performance Report 2018/19](#)

**Dividends**

During the year, we paid dividends of £60.0 million (2018: £55.0 million) to our immediate parent company, Thames Water Utilities Holdings Limited (“TWUHL”), with all of the current year dividends being applied to servicing debt obligations and working capital requirements of other companies within the Kemble Water Group.

No dividends were paid by the Kemble Water Holdings Group to external shareholders for 2018/19 in line with our commitment to withhold paying an external dividend until 2020/21. This commitment will continue to help us increase our equity buffer<sup>1</sup> and broaden financial resilience, to improve our service to customers.

<sup>1</sup> Equity buffer is defined as the regulatory capital value less net debt.

## Section 3

# Disclosures supporting the uses of cash



## Uses of cash

Investors want cash disclosures that:

**Provide detail on uses of cash, both in the past and in the future.**

### Why investors are interested

Once investors have considered how a company generates cash and the quality and sustainability of that generation, they then want to understand what a company intends to do with it. Investors use this to help value the business, and also to support their consideration of the quality of management's stewardship. As the 2018 [strategic report guidance notes](#):

*“For many companies, determining how a company allocates capital may be a principle decision. These capital allocation decisions could include considering working capital requirements, investment, capital expenditure, research and development, capital distribution, and investment in skills and training”*

Given the significance of the decisions, investors and other stakeholders clearly need information that supports their understanding of policy, process and risks.

Many investors and companies in this project felt that in general disclosure about the use of cash was good, either in annual reports or other communications such as investor day presentations. However one area in which further improvement was desired by investors was information that supported users in their own assessments of the future uses of cash.

Through our discussions, investors identified three areas for improvement:

- Disclosure that clarifies priorities for generated and available cash,
- Disclosure to allow assessment of the priorities in action, and
- Clearer explanation of how the priorities are impacted by relevant risks, restrictions and variabilities.

The remainder of this section of the report will consider each of these areas in more detail.

*“It is the bit we like talking about the most, our plans... It is all the most interesting stuff”*

**Company**

*“It is the kind of stuff they generally do well... what they are going to do with the money”*

**Investor**

## Priorities for generated and available cash

At its simplest level, capital allocation is a balance between maintaining and growing the business, and providing resources to other stakeholders.

Differing considerations of the relative priorities will lead to a very different view for investors (and stakeholders) when assessing a company. That is why information about how companies balance different options and stakeholder needs/expectations is useful.

Preparers recognise that, whilst most boards will have clear priorities for the use of cash and capital, it may not be well articulated within the bounds of an Annual Report. This is particularly likely when priorities were set some time ago, or where differing businesses within a group make it difficult to align to a single set of priorities. However, many businesses have more recently taken to creating more structured disclosure, often in the form of a capital allocation framework. This approach is particularly prevalent where companies are launching a new or refreshed strategy. Whilst often the disclosure of a framework provides only a high-level picture of a company's allocation priorities, it can serve to focus investor and management conversations on key aspects of the business. As such users often welcome relevant disclosure. When the capital priority disclosures are connected and linked across disclosures and documents (both inside and outside of the annual report), they can also help users navigate the company's approach.

## Investors and frameworks

Investors taking part in this project were either neutral on frameworks, or considered that these approaches, when done well, were a useful starting point to their assessment of a company. However, they note that such frameworks should be used and applied consistently across time and across communications. Multiple and competing descriptions of priorities are unhelpful.

Investors note that a framework disclosure in itself is not sufficient to give them a full understanding. To better understand, they also need the framework to be supported by evidence of how the priorities are playing out within the current period, and disclosure about how the board makes capital allocation decisions and prioritisations.

*"We used to get lots of questions about our priorities, especially as cash grew, but once we explained our framework and disclosed it all, investors became more focused on outcomes"*

**Company**

## What the market thinks

The Investment Association (IA) undertook a project with their members which detailed the expectations of the investment community on various aspects of Long Term Reporting.

One of the key areas that the report looked at was capital allocation. The IA report highlighted that how well a company utilises its capital has a significant impact on its long term profitability and success. Therefore a key aim for investors is to understand the company's approach in making capital allocations decisions. Companies can support investors in this aim through well-articulated and reasoned narrative on key decisions, supported by qualitative information that allows them to assess the decisions.

These findings were consistent with this project, where investors noted that, whilst frameworks are useful, many would benefit from additional focus around the decision making process.

The full report is available on the IA [website](#)<sup>2</sup>.

<sup>2</sup> <https://www.ivis.co.uk/media/12519/Long-Term-Reporting-Guidance.pdf>

Burberry's Capital Allocation Framework is used to prioritise the use of cash generated by the Group. The framework addresses the investment needs of the business, regular dividend payments and additional returns to shareholders. The framework also seeks to maintain an appropriate capital structure for the business and a strong balance sheet with solid investment grade credit metrics. The diagram below summarises the key priorities.



Maintain a strong balance sheet with solid investment grade credit metrics.

- Review the principal risks of the Group and relevant financial parameters, both historical and projected, including liquidity, lease-adjusted net debt and measures covering balance sheet strength and fixed charge cover.
- These risks and financial parameters are considered by the Board when assessing the viability of the Group, as set out on page 74.

Capital structure metrics	FY 2018/19	FY 2017/18
Net cash	£837m	£892m
Lease-adjusted net debt	(£409m)	(£327m)

Burberry has applied its capital allocation framework during the year ended 30 March 2019 as follows:

- Reinvested £110 million into the business as capital expenditure.
- Increased its full-year dividend by 3% to 42.5p.
- Paid £14.5 million upon completion of the acquisition of a luxury leather goods business, to create a leather goods centre of excellence in Italy. Payments of £11.1 million were made in the year in respect of the acquisition of a non-controlling interest in Burberry Middle East LLC.
- Returned a further £150 million to shareholders via a share buyback programme.

# BURBERRY

LONDON ENGLAND

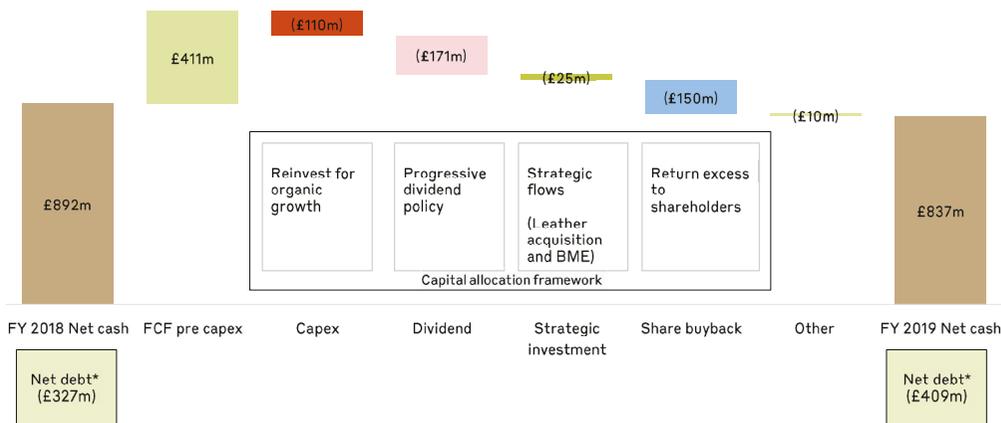
## What is useful?

Burberry has a clear and high-level disclosure on their capital allocation framework that highlights the relative priorities for the use of cash. The framework is further supported with narrative of how they applied the framework in 2018/19. The disclosure makes cross-reference to how the priorities connect with principal risks and how these are then assessed when considering viability.

The framework is also clearly mirrored in the Investor Results Presentation's cash walk, adding to the consistency of reporting.

[Burberry PLC Annual Report 2019](#) and [Investor Results Presentations](#)

## MOVEMENT IN NET CASH



\* Net debt is lease adjusted net debt. This is defined as five times minimum lease payments, adjusted for charges and utilisation of onerous lease provisions, less cash

# CRODA

Strategic Report

## Good capital discipline

Delivering a strong cash flow is core to our strategy; it enables us to invest in R&D, faster growth technologies that are both organic and acquired, expand production capacity and pay increased dividends.

We seek to deliver high quality returns, measured through a superior Return on Invested Capital (ROIC), earnings growth and strong cash returns. The Group's capital allocation policy is to:

<b>Reinvest for growth by:</b>	<b>Provide regular returns to shareholders by:</b>	<b>Acquire promising technologies to:</b>	<b>Maintain appropriate balance sheet and return excess capital to:</b>
<ul style="list-style-type: none"> <li>Investing in capital projects to grow sales, typically each year spending 1.5x depreciation</li> <li>Increasing product innovation</li> <li>Expanding in attractive geographic markets.</li> </ul> <p><b>In 2018 we have invested 2x depreciation in:</b></p> <ul style="list-style-type: none"> <li>Funding asset replacement</li> <li>New investment in key technologies</li> <li>Completing the construction of our pioneering bio-surfactants plant in North America.</li> </ul>	<ul style="list-style-type: none"> <li>Paying a regular dividend representing 40% to 50% of adjusted earnings over the business cycle.</li> </ul> <p><b>In 2018 the Board has proposed:</b></p> <ul style="list-style-type: none"> <li>An increase of 7.4% in the full year dividend to 87.0p (2017: 81.0p)</li> <li>A special dividend of 115.0p per share.</li> </ul>	<ul style="list-style-type: none"> <li>Supplement organic growth in existing and adjacent markets</li> <li>Enhance our strong innovation product pipeline.</li> </ul> <p><b>In 2018 we:</b></p> <ul style="list-style-type: none"> <li>Acquired Nautilus, a marine biotechnology company</li> <li>Acquired Plant Impact, a biostimulants business</li> <li>Acquired Biosector, a leading adjuvant specialist for human and veterinary vaccines</li> <li>Invested in SiSaf, a novel drug delivery technology company</li> <li>Increased our investment in Cutitronics, the multi-award winning digital device company.</li> </ul>	<ul style="list-style-type: none"> <li>Meet future investment and trading requirements; with</li> <li>A target leverage of 1.0 to 1.5x (excluding deficits on retirement benefit schemes).</li> </ul> <p><b>In 2018:</b></p> <p>After the acquisition of Biosector, leverage increased to 1.1x. In light of our strong performance and improving cash generation, the Board is proposing a return of £150m excess capital to shareholders by way of a special dividend. The effect of this return would have been to increase the 2018 year-end leverage towards the upper end of the Board's target range.</p>
<b>ROIC</b>  <b>18.2%</b> <small>2017: 19.2%</small>	<b>Acquisitions</b>  <b>£82.5m</b> <small>2017: £30.4m</small>	<b>Ordinary dividend</b>  <b>87.0p</b> <small>2017: 81.0p</small>	<b>Leverage</b>  <b>1.1x</b> <small>2017: 1.0x</small>
<b>Net capital expenditure</b>  <b>£103.1m</b> <small>2017: £157.2m</small>			

## Our Strategy continued

# How we invested in 2018

**'Stretching the Growth' focuses on accelerating sales in our core sectors; creating more technology, new and protected products and intellectual property; and taking a disciplined approach to capital allocation.**

In line with our disciplined capital allocation policy, we invest in high capital return opportunities to deliver superior shareholder value. In order to achieve this, we are investing in six key areas.

### Sustainability leadership

We are passionate about sustainability, because it is the right thing to do and an integral part of how our sustainable ingredients add value to our customers' products. Our bio-surfactants plant will see the launch of our ECO range of sustainably focused ingredients.

The publication of the United Nations Sustainable Development Goals (SDGs) is providing growth opportunities for our business. The SDGs are a commitment to tackling some of the more pressing challenges facing the world today and, in 2018, our Executive Committee worked with Cambridge Institute for Sustainability Leadership to develop our sustainability strategy in alignment with the SDGs.

### Innovation Partnering

Our Open Innovation and Smart Partnering Programmes continue to evolve. We now have more than 450 partners, comprising over 100 completed and 85 ongoing projects with academics, universities, start-ups and technology enterprises. In 2018 we acquired Nautilus, from one of our smart partners.

Along with our smart partner Glassflake, we developed and launched a range of Moonshine™ ingredients in 2018, a new offering in colour cosmetics. We also completed an investment and a commercial arrangement with SiSaf, a pioneering UK based bio-pharmaceutical company.

### Greater R&D

We have a relentless focus on innovation. In constant currency, new and protected product (NPP) sales have grown by 85% since 2012, from 20.5% of total sales to 28.2% today. Personal Care has the richest innovation, with NPP sales accounting for 43% of total sector sales.

Life Sciences has a healthy innovation pipeline and is expected to deliver fast growth in NPP sales. Performance Technologies has increased its proportion of NPP sales to 18% as the sector transitions to a higher technology business.

We continue to invest in our global R&D capabilities with new facilities in North America, China and Singapore. We have also enhanced our R&D capabilities at Sederma and expanded our crop care facility in Brazil.

### Disruptive Technology-led acquisitions

We continue to invest in disruptive technology as part of our strategy to 'Stretch the Growth'. The integration of an innovative technology provider of static electricity dissipation for electronic and automotive applications, IonPhasE, is nearing completion. This acquisition has created openings in new fast growing, niche end markets.

In Health Care, we acquired Biosector, a vaccine adjuvant specialist, seen as a natural extension of our existing pharmaceutical excipients portfolio.

### Premium niches

Many of our markets are experiencing a 'flight to premium'. We continue to experience high levels of demand for our Sederma anti-ageing skin actives, which is why we have recently doubled R&D and enhanced production capacity. We have increased capacity in our solar protection business to support the growth of our Solaveil™ range of ingredients.

We are expanding manufacture of our high purity excipients as demand continues to grow rapidly. In Brazil, we invested in capacity for our Crop Care adjuvants, providing us with new exciting opportunities. In the UK, we are expanding our polymer additive manufacturing capacity.

### Digitalisation

Digitalisation is an emerging differentiator for our business, creating many opportunities. We have invested in global digital resource and established a Digital Centre of Excellence to take advantage of this fast-evolving digital world.

We focus our efforts on better connecting with our customers. We created entrepreneurial cells in Digital Marketing and Data Analytics that will drive an improved customer experience through our digital channels. In Canada, we opened the Nautilus Biosciences Croda Centre of Innovation for Marine Biotechnology.

## What is useful?

Croda's disclosure provides an overview of their key priorities and then provides additional detail about what this means in practice, with examples from the current year and key relevant metrics.

The disclosure is further enhanced by being located in the context of the strategy and business model disclosures. On the opposing page, the company also highlights key investments from 2018 which gives further relevant areas for users to consider.

[Croda Annual Report and Accounts 2018](#)



**Disciplined approach to capital allocation**

Our asset-light business model is highly cash generative and enables us to invest in our brands. We have a disciplined approach to capital allocation ensuring that the business is appropriately invested in whilst maintaining an efficient balance sheet.

Our priorities for the uses of cash are consistent with previous years and comprise of:



**1. Invest in the business**

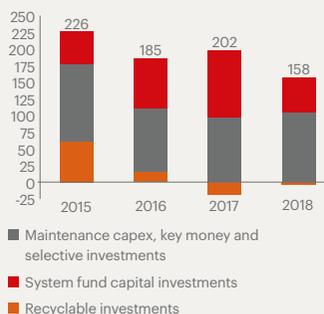
Beyond this, we look to return surplus cash to shareholders through ordinary and special dividends and share buybacks.

Our objective is to maintain an investment grade credit rating. One of the measures we use to monitor this is net debt:EBITDA and we aim for a ratio of 2.0-2.5x. The ratio at 31 December 2018 was 1.7x. Following the adoption of IFRS 16 'Leases' (see page 115), from 1 January 2019 we will aim to maintain a net debt:EBITDA ratio of 2.5-3.0x, which is equivalent to our guidance under the previous accounting standard.

Through strategic investments and our day-to-day capital expenditures we continue to drive growth.



**Capital investments net (\$m)**



*"I mean if I could get something like this for all the companies I invest in it would be great, it is simple but it works"*

**Investor**

**What is useful?**

IHG has taken a more narrative approach to describing their capital allocation priorities. The clear disclosure is further enhanced by supporting detail of net capital investment, ordinary dividend progression and shareholder return. The company also highlights the dividend decision for the current period. This provides users with a quick overview.

[IHG Annual Report and Form 20-F 2018](#)

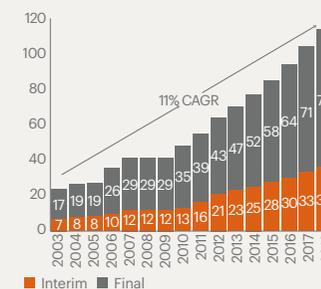
**Final dividend**

The Board has proposed a final dividend per ordinary share of 78.1¢. With the interim dividend per ordinary share of 36.3¢, the full-year dividend per ordinary share for 2018 will total 114.4¢.

**2. Maintain sustainable growth in the ordinary dividend**

IHG has a progressive dividend policy which means we look to grow the dividend per ordinary share each year.

**Ordinary dividend progression (¢)**



**3. Return surplus funds**

In October 2018, we announced a \$500m capital return to shareholders via a special dividend and share consolidation. The special dividend was paid on 29 January 2019.

**Shareholder returns 2003-18 (\$bn)**



## Priorities in action

Once investors are clear on management’s priorities, they then want information on the prioritisation of these in the period, and how current decisions might impact future flows.

Detail regarding capital expenditure, dividends and other returns are critical to achieving this understanding, as they help demonstrate whether management actions are aligned to the priorities.



### Investing in the business

Capital expenditure decisions are often key elements of a company’s strategy. Investors note that whilst high-level disclosure on total capital expenditure is often found within the annual report, what is lacking is the detail behind the aggregate numbers. Investors need such disclosure as it helps them to understand both future capacity (and therefore cash flow) and any concern about window dressing from under-investment. One way of generating cash within a business is by under-investing in the existing or growth-orientated capital asset. This boosts cash in the short-term, but it is likely to do so at the expense of the longer-term prospects of the business.

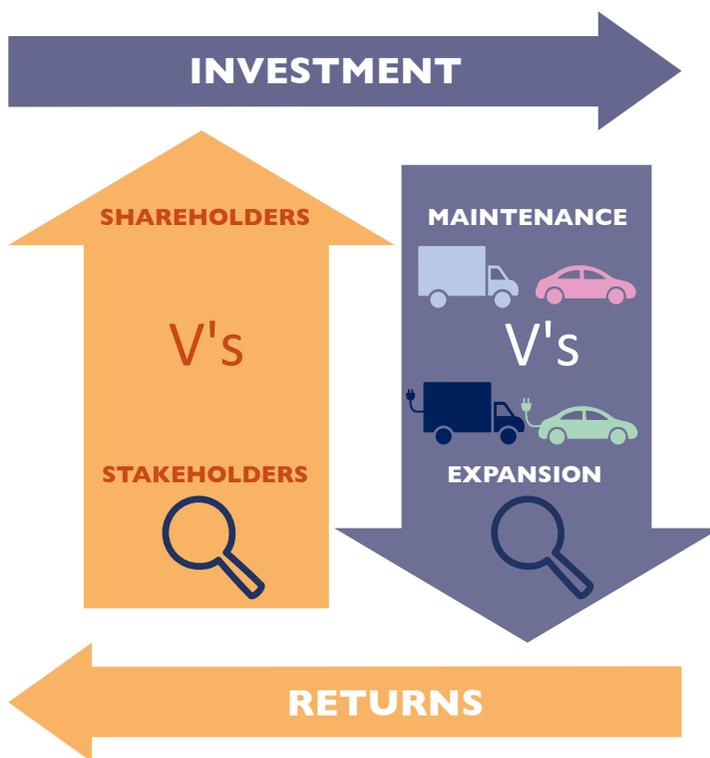
To help them answer these questions, particularly for companies that are asset intensive, many investors want capital expenditure split between relevant 'functions' (such as country, product or division) and 'purpose' (such as growth vs maintenance).

Some investors question the value of 'purpose' categories which they view as a subjective split (because of a lack of comparability and consistency across companies); others consider that, if used consistently within a company, it is useful. Furthermore, many investors consider that the value of such disclosure is enhanced when it is placed within the audited sections of the annual report. As well as historical information, investors are also keen to obtain information about future expectations for capital expenditure, as these help to improve the quality of their forecasts.

Preparers noted that such splits in CapEx only had value where they are aligned to how the business viewed CapEx itself, and such splits feed into management information, reporting and decision making.

We considered a number of examples of disclosure with investors, and have selected AngloAmerican as an example of detailed accounts-based disclosure, and Carnival, who provide some future orientated disclosure.

Cap-Ex disclosures help show levels of current investment and provide insight into the quality of current and future cash generation.



Disclosures about returns help in the assessment of the future balance between shareholder and other stakeholder.

### GROUP CAPITAL EXPENDITURE\*

Capital expenditure increased to \$2.8 billion (2017: \$2.2 billion), with rigorous capital discipline continuing to be applied to all projects. Sustaining capital increased to \$2.5 billion (2017: \$2.1 billion), driven by stronger average local currencies, planned additional stay-in-business expenditure across the Group, in line with our increased production base, and increased capitalised development and stripping expenditure primarily due to longwall productivity improvements at Metallurgical Coal and an optimisation of the mine plan at Mogalakwena. In 2019, we expect total capital expenditure to increase to \$3.8-\$4.1 billion after utilising the remaining \$0.5 billion of capital expenditure funding for Quellaveco from the Mitsubishi subscription.

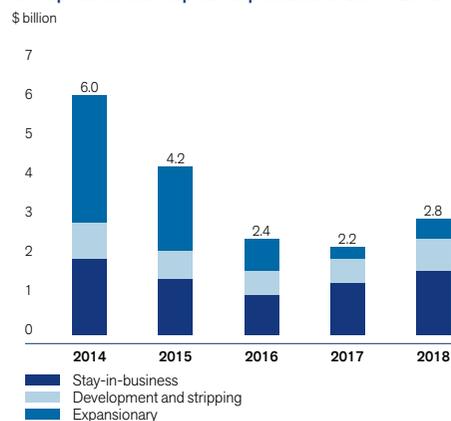
Strategic report

#### Capital expenditure\*

\$ million	2018	2017
Stay-in-business	1,617	1,310
Development and stripping	796	586
Life extension projects <sup>(1)</sup>	245	216
Proceeds from disposal of property, plant and equipment	(162)	(52)
<b>Sustaining capital</b>	<b>2,496</b>	<b>2,060</b>
Growth projects <sup>(1)</sup>	340	168
<b>Total</b>	<b>2,836</b>	<b>2,228</b>
Capitalised operating cash flows	(18)	(78)
<b>Total capital expenditure</b>	<b>2,818</b>	<b>2,150</b>

<sup>(1)</sup> Life extension projects and growth projects are collectively referred to as expansionary capital expenditure.

#### Group historical capital expenditure\* 2014–2018



### What is useful?

In these extracts from the Annual Report, AngloAmerican provides a breakdown of the capital expenditure for the year categorised by strategic orientation (e.g. Sustaining capital vs Growth Projects). Further context is given by a 5yr historical split.

The note in the financial statements also provides a split of the same numbers by segment and reconciles through to cash flow.

[AngloAmerican plc Integrated Annual Report 2018](#)

#### 12. CAPITAL EXPENDITURE

The disclosures in this note include certain Alternative Performance Measures (APMs). For more information on the APMs used by the Group, including definitions, please refer to page 208.

##### Capital expenditure by segment

US\$ million	2018	2017
De Beers	417	273
Copper	703	665
Platinum Group Metals	496	355
Iron Ore	415	252
Coal	722	568
Nickel and Manganese	38	28
Corporate and other	27	9
<b>Capital expenditure</b>	<b>2,818</b>	<b>2,150</b>
<b>Reconciliation to Consolidated cash flow statement:</b>		
Cash flows from derivatives related to capital expenditure	15	40
Proceeds from disposal of property, plant and equipment	162	52
Direct funding for capital expenditure received from non-controlling interests	374	36
Reimbursement of capital expenditure	31	-
<b>Expenditure on property, plant and equipment</b>	<b>3,400</b>	<b>2,278</b>

Direct funding for capital expenditure received from non-controlling interests represents capital expenditure relating to the Quellaveco project funded by cash subscriptions from Mitsubishi. This is deducted in order to present capital expenditure on an attributable basis. The remaining \$515 million of cash subscription, received as part of the Quellaveco syndication transaction, will be offset against capital expenditure on the Quellaveco project in 2019. See note 25 for a full description of the transaction.

Reimbursement of capital expenditure relates to funding provided for the development of the Charterhouse Street office.

##### Capitalised operating cash flows

Capital expenditure includes net capitalised operating cash inflows of \$18 million (2017: net inflows of \$78 million) generated by operations prior to reaching commercial production for accounting purposes.



### Sources and Uses of Cash

#### Operating Activities

Our business provided \$5.5 billion of net cash from operations during 2018, an increase of \$227 million, or 4.3%, compared to \$5.3 billion in 2017. This increase was driven by an increase in customer deposits. During 2017, our business provided \$5.3 billion of net cash from operations, an increase of \$188 million, or 3.7%, compared to \$5.1 billion in 2016. This increase was caused by an increase in our revenues less expenses settled in cash.

#### Investing Activities

During 2018, net cash used in investing activities was \$3.5 billion. This was caused by:

- Capital expenditures of \$2.1 billion for our ongoing new shipbuilding program
- Capital expenditures of \$1.7 billion for ship improvements and replacements, information technology and buildings and improvements
- Proceeds from sale of ships of \$389 million
- Purchase of minority interest of \$135 million
- Payments of \$39 million of fuel derivative settlements

During 2017, net cash used in investing activities was \$3.1 billion. This was caused by:

- Capital expenditures of \$1.4 billion for our ongoing new shipbuilding program
- Capital expenditures of \$1.5 billion for ship improvements and replacements, information technology and buildings and improvements
- Payments of \$203 million of fuel derivative settlements

During 2016, net cash used in investing activities was \$3.3 billion. This was caused by:

- Capital expenditures of \$1.9 billion for our ongoing new shipbuilding program
- Capital expenditures of \$1.2 billion for ship improvements and replacements, information technology and buildings and improvements
- Payments of \$291 million of fuel derivative settlements
- Proceeds from sale of ships of \$26 million

### Future Commitments

(in millions)	Payments Due by						Total
	2019	2020	2021	2022	2023	Thereafter	
Debt (a)	\$ 2,633	\$ 2,320	\$ 1,243	\$ 1,203	\$ 1,867	\$ 2,095	\$ 11,360
Other long-term liabilities reflected on the balance sheet (b)	—	135	90	73	59	178	535
New ship growth capital	4,935	3,849	3,887	3,117	2,110	1,132	19,029
Operating leases	70	48	46	36	35	180	415
Port facilities and other	311	292	249	172	132	1,097	2,253
Purchase obligations	451	—	—	—	—	—	451
<b>Total Contractual Cash Obligations</b>	<b>\$ 8,400</b>	<b>\$ 6,644</b>	<b>\$ 5,514</b>	<b>\$ 4,600</b>	<b>\$ 4,203</b>	<b>\$ 4,682</b>	<b>\$ 34,044</b>

(a) Includes principal as well as estimated interest payments.

(b) Represents cash outflows for certain of our long-term liabilities which can be reasonably estimated. The primary outflows are for estimates of our compensation plans' obligations, crew and guest claims and certain deferred income taxes. Customer deposits and certain other deferred income taxes have been excluded from the table because they do not require a cash settlement in the future.

### What is useful?

Carnival provides a high-level narrative on key aspects of uses of cash for the current and prior two years. Carnival also provides a summary of the timing of future commitments and capital expenditure.

These are very useful for investors who want to project future cash generation.

[Carnival Corporation & PLC Annual Report 2018](#)

### Capital Expenditure and Capacity Forecast

Our annual capital expenditure forecast consists of contracted new ship growth capital, estimated payments for planned new ship growth capital and capital improvements.

(in billions)	2019	2020	2021	2022
Annual capital expenditure forecast	\$ 6.8	\$ 5.7	\$ 5.9	\$ 5.4

Our annual capacity forecast consists of contracted new ships and announced dispositions.

	2019	2020	2021	2022
Annual capacity forecast	4.6%	5.5%	7.2%	5.2%

## Distributions to shareholders

Where cash is surplus to business requirements, either through the normal operation of the business, or as a part of a disposal, and can be distributed under the capital maintenance regime, companies will often either return this to shareholders or use it to meet or accelerate other stakeholder commitments. These are all flows of cash outside of the company.

Investors in this project noted that generating expectations as to when returns will occur, its likely quantum and the sustainability of such flows is useful to those seeking to value and assess companies. In addition, many investors consider that information on dividend capacity and resources (Cash and distributable reserves) is critical to their assessment of management's stewardship, and necessary for them to be able to properly approve a dividend.

Again, this is an area where company disclosure often falls short. High-level disclosure is of limited value to investors who would welcome more definitive and detailed information.

Particular areas for improvement include:

- Disclosure on the timing and size of any returns,
- Disclosure on the availability and nature of dividend resources currently accessible to the parent company, and
- Details about risks, restrictions and variabilities that might impact returns in the future.

Preparers noted that not all of these issues are relevant to all companies, and therefore the level and detail of disclosure should be dependent upon the importance of each element to the company's specific circumstances.

### Timing of returns

Investors continuously make investment decisions that are optimised for different time horizons. They therefore require specific details about the timetable and nature of any large or unusual returns (e.g. Special Dividend vs Share buyback vs Enhanced ordinary dividend). This is critical to investors in positioning their investment. Whitbread is a good example of a company that provides clarity. The disclosure on the following page was published alongside the announcement of a large transaction, which generated significant cash. It details the mix of stakeholders that would obtain some of the proceeds, and also the timetable for further information.

### What the market thinks

The Investment Association (representing the Investment Management industry) were recently tasked by Government to investigate the prevalence of dividends being paid without a corresponding vote by shareholders. Their report highlights that this is surprisingly common. The report also concludes that companies should consider improving current dividend disclosure:

*“the IA recommends that all listed companies, including those that put a dividend resolution to shareholders, should as a minimum, articulate a ‘distribution policy’. This policy should set out their long-term approach to making decisions on the amount and timing of returns to shareholders, including dividends, share buybacks and other capital distributions within the context of any relevant legal or financial constraints.”*

Their full report can be found [here](#)<sup>3</sup> Further guidance is expected from the IA in Autumn 2019.

<sup>3</sup> <https://www.theia.org/sites/default/files/2019-05/20190528-shareholdervotesondividenddistributionsinuklistedcompanies.pdf>



# WHITBREAD

## What is useful?

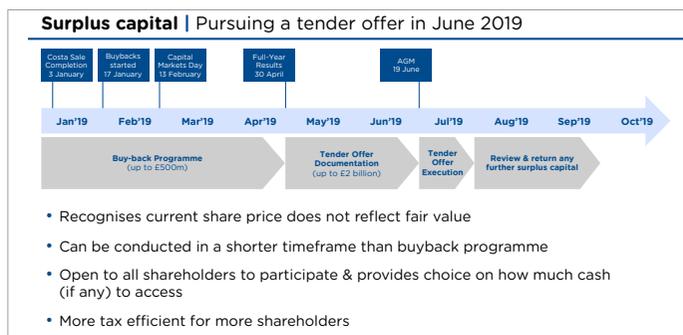
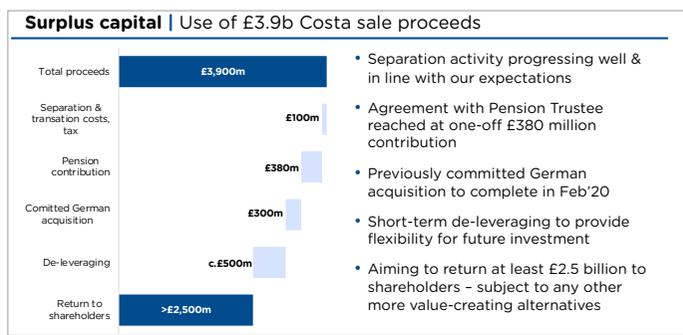
In these extracts Whitbread provides high-level details of the expected use of the proceeds from the sale of a significant subsidiary (Costa). This provides some clarity as to how the proceeds will flow through to stakeholders. The company provided further disclosure in the capital markets day which gave more detail on uses and timing of any returns.

[Whitbread Plc Proposed sale of Costa Investor Presentation 2018](#) and [Capital Market Day 2019](#)

### Use of proceeds

- Transaction and separation costs of approximately £100 million
- Significant majority of net proceeds to be returned to shareholders
- Appropriate routes to return proceeds considered at completion
- Pension Trustees and some debt providers require consultation
- Strategic progress and future plans discussed at capital markets day in early 2019

- Highly attractive transaction benefitting all stakeholders
- Recognises strategic value of brand & international potential
- Enterprise value of £3.9 billion (Costa FY18 EBITDA)
- Significant majority of net proceeds to be returned to shareholders
- Transaction is conditional on shareholder & other approvals
- Whitbread to focus on attractive structural growth opportunities for Premier Inn in the UK & Germany



## Lab comment: Disclosure of Dividends

The Lab's previous work on dividends: [Disclosure of dividends – policy and practice](#) showed that disclosures that allowed investors to understand a company's policy on dividends, and the capacity to maintain that policy over the medium-term, were fundamental to their assessment of stewardship (in the current period) and the longer-term value and sustainability of the company.

Investors considered that good dividend disclosures should answer the following questions:

- Why this policy?
- What will the policy mean in practice?
- What are the risks and constraints associated with this policy?
- What was done (in practice) to deliver under the policy?

The investors taking part in this project echo the same conclusions; understanding dividends is critical to understanding the company.

However, not all companies provide sufficient disclosure to allow investors to fully assess dividends in the current or future periods.

The original report recommended specific enhancements to dividend policy and dividend practice disclosures that would be of value to investors. These include:

**Dividend policy disclosures** – Lab project participants identified good disclosure as providing:

- an understanding of the board's considerations in setting the policy,
- the rationale for the approach selected, and
- sufficient detail to understand how the policy will operate.

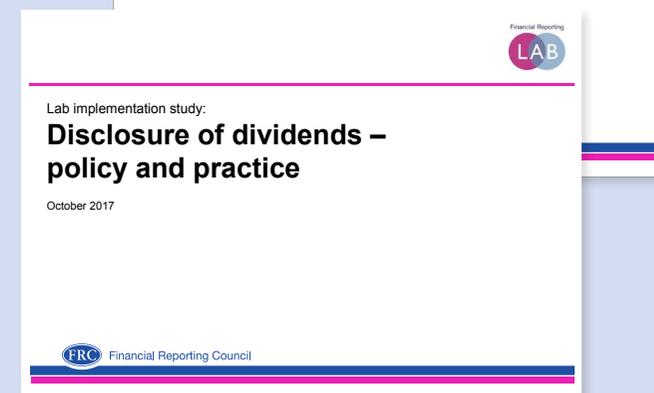
**Dividend practice disclosures** – Lab project participants identified good disclosure to include:

- the key judgements and constraints considered by the board in applying the dividend policy,
- the availability of dividend resources, including cash and distributable profits, to pay dividends (this was considered particularly useful in situations where either was a constraining factor), and
- clear linkage from the disclosed policy to its application in the period. Bringing together various elements of disclosure to provide a focused narrative was considered helpful to investors.

For more details of our findings please read the original reports or the implementation studies:



[Original report](#)



[Implementation studies](#)

## Disclosure on the availability and nature of dividend resources

The Lab's previous work on dividends: [Disclosure of Dividend – Policy and practice](#) showed the availability of dividend resources, including cash and distributable profits, to pay dividends was a key piece of information from many investors and was considered particularly useful in situations where the current or future availability of dividend resources was likely to be a constraining factor. It was also an area of practice where disclosure was often poor or non-existent. In the intervening period, the demands by investors for better disclosure in this area have grown.

A number of investors taking part in this project also raised issues in this area. Whilst there have been moves made by companies to clarify the availability of resources to pay dividends, often by stating the amount in the parent entity, this is frequently done only where resources are abundant. In situations where the parent relies on dividend resources

from the rest of the group, greater clarity about where those resources are within the group is welcomed by investors. For investors this is not purely about the affordability of the current proposed dividend/policy (although this is important), it is also about understanding the interaction between the underlying businesses, their ability to generate cash and furnish that cash to the holding company for wider use; this directly impacts on valuation.

During the project we considered a number of examples that attempted to answer investors' questions on dividend resources. Whilst we found disclosures (in Drax) that conveyed the link between the holding company's dividend and cash from below the holding company, and disclosures which linked cash generation and affordability of dividend (Chesnara) we did not find disclosures that covered the location of cash within a group. To show what might be possible in this area, the Lab created an example based on the discussions we held with investors and companies (see box).

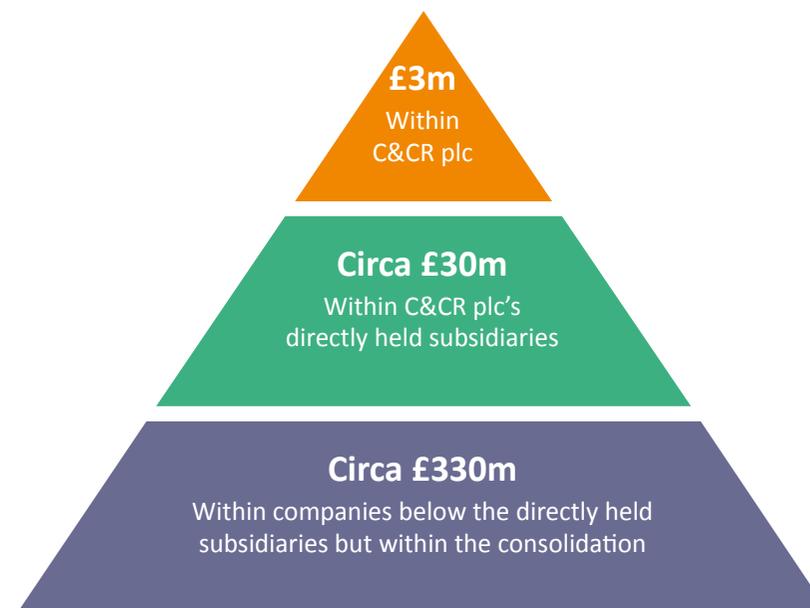
### What is useful?

In this example, constructed by the Lab, Clear and Concise Reporting plc highlights where the cash resources are within the group, and provides narrative that covers the impact that this has on the overall dividend capacity of the company. This level of disclosure would be helpful in situations where cash (and/or distributable profits) are a constraining factor, or information about the overall group structure is important to understand the group's ability to support dividends.

## Lab example

CLEAR & CONCISE REPORTING PLC

Page 34



### The structure of cash and liquid resources as at the 31/12/2018

#### Dividend resources

Clear & Concise Reporting plc, as the parent holding company of the group, holds limited cash resources directly, with most of the cash and liquid resources deployed in the operating subsidiaries. As such, when considering the group's ability to pay dividends, the directors consider first the availability of cash and distributable profits in the parent company as well as in the directly held subsidiaries. Whilst we consider that cash held below the direct subsidiary is ultimately available to the group, we consider that the time frame and process involved in remitting that to group means that it should not be considered in our shorter term dividend consideration. Although at the year end the company had enough distributable profits (£40m) to pay the proposed dividend (£20m) it did not have enough cash resources. The directors of Clear Concise London (one of the group's directly held subsidiaries) announced on the 01/01/2019 that they would be paying a dividend to Clear & Concise Reporting plc of £18m. The dividend was received on the 03/02/2019. Given the post balance sheet receipt of the Clear Concise London dividend, the directors of Clear & Concise Reporting plc consider it appropriate to propose the £20m dividend for 2018.

Clear & Concise Reporting Plc accounts p120



### What is useful?

Chesnara shows how the cash generated by the group (adjusted for exceptional items) relates to the level of dividends that the company pays to the shareholders. This provides investors with information about the affordability of the dividend policy in the period. The company also juxtaposes the disclosure by highlighting that its primary responsibility is to its policyholders, and therefore there is a balance between shareholder returns and policyholders.

[Chesnara Annual Report and Accounts 2018](#)

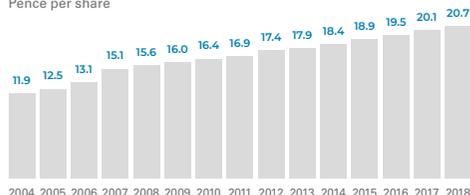


#### DIVIDEND HISTORY

##### 14 SUCCESSIVE YEARS OF DIVIDEND GROWTH

We recognise the importance of providing stable and attractive dividends to our shareholders. A full year 2018 dividend of 20.67p per share represents an increase of 3% on the prior year, and is Chesnara's fourteenth successive year of dividend growth.

Dividend per share history  
Pence per share



#### POLICYHOLDERS

##### OUR PRIMARY RESPONSIBILITIES REMAIN TO OUR POLICYHOLDERS

- Customers can be confident that they have policies with a well capitalised group where financial stability is central to our culture and values.
- Our investment returns remain competitive across the group.
- We deliver good customer service levels across the group.



### What is useful?

Drax's disclosure in the parent company's accounts clarifies that, whilst the top company has sufficient distributable profits to pay out the proposed dividend, the company will need cash resources from its subsidiaries. This provides investors with an understanding as to where the dividend resources (cash and distributable profits) that fund the proposed dividend will come from.

[Drax Annual Report and Accounts 2018](#)



#### 7. DISTRIBUTABLE RESERVES

Note 8 sets out the proposed final dividend of £33.6 million in respect of 2018.

The Company considers its distributable reserves to be comprised of the profit and loss account less treasury shares, with a total value of £233.6 million. Accordingly, the Company considers itself to have sufficient distributable profits from which to pay the current year final dividend. Based on a total dividend for 2018 of £56.0 million, the Company has sufficient distributable reserves to pay four years of dividend at the current level without generating further distributable profits. In addition to its own reserves, the Company has access to the distributable reserves of its subsidiary undertakings with which future dividend payments can be funded (see note 2.10 to the consolidated accounts for additional information).

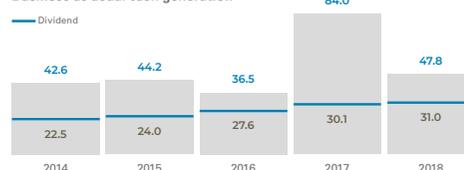
The Company is dependent upon its subsidiaries for the provision of cash with which to make dividend payments. As shown in note 4.2 to the consolidated financial statements, the Group has sufficient cash resources with which to meet the proposed dividend.

#### CASH GENERATION

##### CASH GENERATION CONTINUES TO SUPPORT DIVIDENDS

Ultimately the group needs to generate cash to service its dividends. We define cash generation as the movement in the group's surplus own funds above the group's internally required capital. Cumulative cash generation over the last 5 years represents c190% of the total dividends over the same period.

Business as usual cash generation\*



\*The chart illustrates how business as usual cash generation compares to the total shareholder dividend. For this purpose the cash figure is based on divisional cash generation plus non-exceptional group items. To include exceptional items would mislead in terms of illustrating the effectiveness of the core business in funding the dividend.

## Disclosures on variabilities, risks and restrictions

Investors noted that, in order to properly assess the future potential upside of a business, they need to be able to assess the downside. When thinking about future availability of cash that means they need information on:

- Variability of future outcomes - How does the company consider the range of possibilities for future cash use and how does that feed through to the prioritisation of decisions?
- Risks – What is the link between the risks facing the company and the outturn in cash generation, use, and dividend?
- Restrictions – Are there any restrictions on current or future cash, either through capital or exchange controls, availability of dividend resources or other items?

**Variabilities** - Investors understand that returns are variable and should reflect the changing focus and priorities of the company, the call of other stakeholders, and the availability of resources. Investors therefore value information that helps them understand management's potential reaction to that variability.

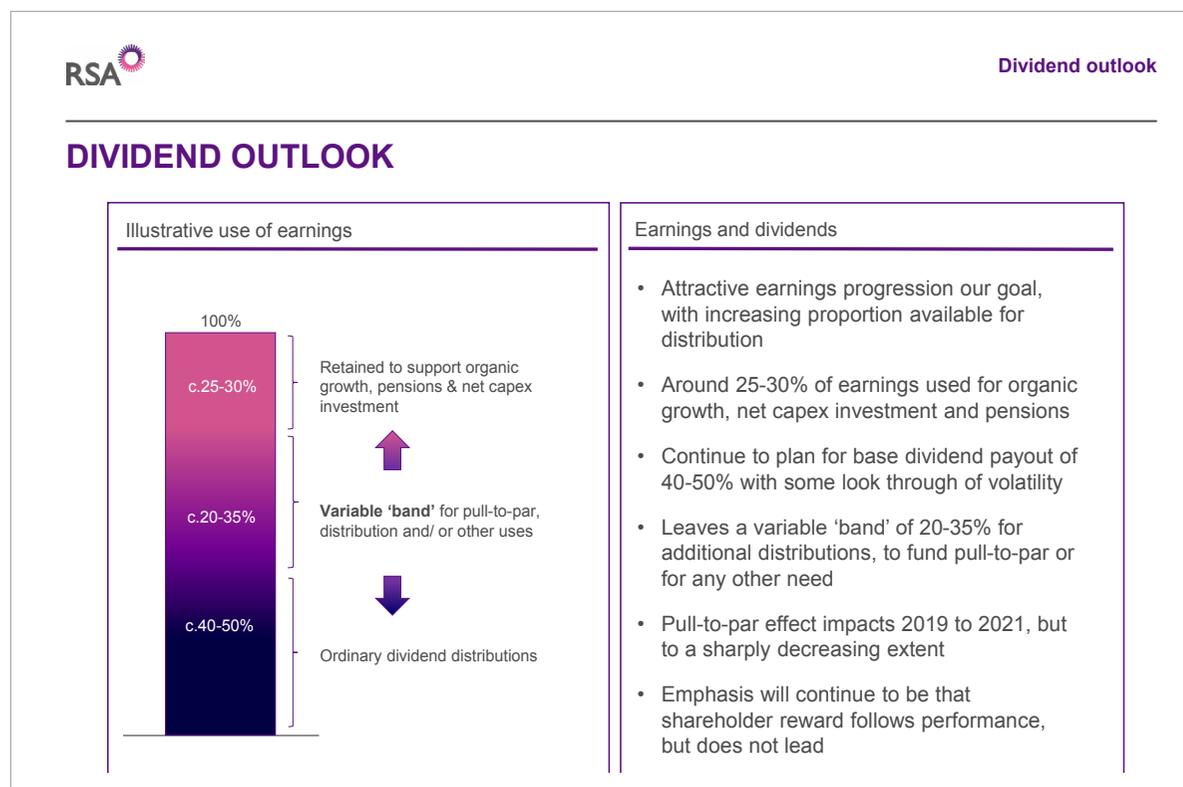
Preparers are often concerned with providing too much definitive detail in case the outturn is not as expected. However, investors are generally comfortable with some uncertainty as this allows them to make their own judgements on the likely outturn. Both the examples we selected (RSA and Phoenix) find a middle-ground between insight and detail which is acceptable to both companies and investors.



### What is useful?

RSA provides some information in their investor presentation which illustrates how future earnings might feed through into organic growth and dividends. It highlights the overall range as well as a variable band, which are useful factors for investors to consider.

[RSA Plc Preliminary Announcement Presentation 2018](#)



## Risks

Participants in this project noted that information that supports them in assessing the likelihood and magnitude of risks, and the resultant sensitivity to either the generation of cash, or calls on that cash, is fundamental to their investment decision-making.

In practice, this means that investors want detail about how the company's principal (and significant) risks might impact the outturn for cash, and/or the balance of the priorities for the use of that cash.

For many investors it is sufficient for disclosures to be delivered as part of a well executed principal risk disclosure section. Relatively high-level disclosure can be given to good effect with such techniques as indicator arrows showing the likely flow through of risks to KPIs or strategic priorities or via simple narratives.

Our recent report on [Risk and viability reporting](#) provides a number of interesting examples on risk reporting.

However, for some investors, high-level disclosure is not sufficient. This is particularly the case where capital requirements are an important part of understanding the availability of cash, or where the availability of cash and liquid resources is itself a principal risk or factor in the company's viability assessment.



## PHOENIX GROUP

### What is useful?

Phoenix provides investors with details of how certain scenarios might impact total cash generation. Whilst the disclosure makes no direct commitment on dividends it highlights that under the scenarios presented, cash generation remains sufficient to fund dividend and operating expenses.

[Phoenix Full Year Results 2018](#)

### Resilience of cash generation increases confidence in our dividend

#### Sensitivities for £3.8 billion expected cash generation between 2019-23<sup>(1)</sup>

Uses of cash	Operating & interest costs of £1.1bn	Dividend of £1.7bn	Impact on cash generation
2019-23 expected cash generation			£3.8bn
20% fall in equity markets			£3.8bn
15% fall in property values			£3.7bn
60bps rise in interest rates <sup>(2)</sup>			£3.9bn
80bps fall in interest rates <sup>(2)</sup>			£3.7bn
120bps credit spread widening <sup>(3)</sup>			£3.6bn
10% increase/decrease lapse rates <sup>(4)</sup>			£3.4bn
6 months increase in longevity <sup>(5)</sup>			£3.3bn

(1) Scenario assumes stress occurs on 1 January 2019

(2) Assumes recalculation of transitionals (subject to PRA approval)

(3) Credit stress equivalent to an average 120bps spread widening across ratings and includes allowance for defaults/downgrades

(4) Assumes most onerous impact of a 10% increase/decrease in lapse rates across different product groups

(5) Applied to the annuity portfolio



## Restrictions

For some companies it is important for investors to understand the existence and, more crucially the nature of, any restrictions on cash balances. Current requirements under IFRS 7 require companies to disclose any restrictions on cash. Whilst this can provide investors with information, in practice disclosure is often not fulsome.

Two examples considered by investors in this project sought to go further by providing extra detail about the nature of such balances, how they are managed (Anglo-American), and the context of the restrictions in relation to overall performance (Wizz).

Both of these examples were deemed useful by investors as they provided greater transparency of a particular factor important to the understanding of the company.

### What is useful?

AngloAmerican provides a detailed breakdown of the amounts of cash and debt within South Africa, and disclose the nature of cash restrictions. They also highlight that net cash/net debt are monitored separately for the impacted operations.

[AngloAmerican plc Integrated Annual Report 2018](#)



#### South Africa net cash

The Group operates in South Africa where the existence of exchange controls may restrict the use of certain cash balances. The Group therefore monitors the cash and debt associated with these operations separately. These restrictions are not expected to have a material effect on the Group's ability to meet its ongoing obligations. On an owned basis cash and cash equivalents in South Africa is \$5,316 million (31 December 2017: \$4,276 million) and net cash is \$4,603 million (31 December 2017: \$3,446 million).

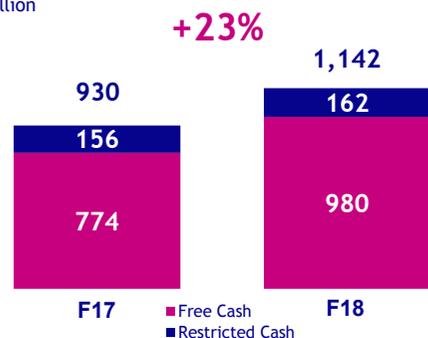
As part of the Group cash pooling arrangement cash that is legally owned by South African companies is managed outside of South Africa. Below is a breakdown of net cash managed in South Africa.

US\$ million	2018	2017
Cash and cash equivalents	1,382	1,651
Short term borrowings	(113)	(34)
Medium and long term borrowings	(601)	(798)
<b>Net cash excluding derivatives</b>	<b>668</b>	819
Derivatives hedging net debt	1	2
<b>Net cash including derivatives</b>	<b>669</b>	821



## FY18 | HIGHER CASH GENERATION

€ million



- Strong cash generation
- Investment grade balance sheet
- Multiple aircraft financing options
- Two additional aircraft orders requiring aircraft deposits
- Cash collateral on LC facilities
- Maintaining or lowering leverage
- IFRS16 debt at €1.5bn, reducing to €1.3bn end FY19



Audited financial statements.  
 Note 1: Cash and Cash Equivalents (€m)  
 Note 2: Leverage is defined as net debt adjusted to include capitalised operating lease obligations divided by earnings before interest, tax, depreciation, amortisation and aircraft rentals.

FY18 Results  
 Page 12



### What is useful?

Wizz shows the relationship between Free Cash, Restricted Cash and total cash.

Wizz clearly shows on each page of the presentation whether the numbers are from audited or unaudited sources. This allows investors to assess the level of reliability of the disclosure.

[FY2018 Results 24 May 2018](#)

Audited financial statements.  
 Note 1: Cash and Cash Equivalents (€m)  
 Note 2: Leverage is defined as net debt adjusted to include capitalised operating lease obligations divided by earnings before interest, tax, depreciation, amortisation and aircraft rentals.

## Thanks

Participation in the project comes either through response to a public call or being approached by the Lab. An iterative approach is taken, with additional participants sought during the project, though it is not intended that the participants represent a statistical sample. References made to views of 'companies' and 'investors' refer to the individuals from companies and investment organisations with whom the Lab interacted in this project. Views do not necessarily represent those of the companies or organisations. Views were received from a range of UK and international institutional investors, analysts, retail investors and from a range of companies through FRC-led roundtables, one-to-one interviews, short calls or roundtables with other agencies.

## We would like to thank the following who have provided input into the project:

### Companies

4imprint Group  
 Adnams Plc  
 AngloAmerican Plc  
 AstraZeneca Plc  
 AutoTrader Group Plc  
 Burberry Group Plc  
 Carnival Corporation & Plc  
 Chesnara Plc  
 Croda International Plc  
 Deltex Medical Group Plc  
 Drax Group Plc  
 InterContinental Hotels Group PLC  
 J Sainsbury Plc  
 Johnson Matthey PLC  
 M&C Saatchi Plc  
 Mears Group Plc  
 Phoenix Group Holdings PLC  
 RioTinto Plc  
 RSA Group Plc  
 Thames Water Utilities Ltd  
 Whitbread Plc  
 Wizz Air Holdings Plc

### Investors

Allianz Global Investors  
 CFA Institute  
 Evenlode Investments  
 Go Investment Partners  
 Moody's Investors Service  
 Schroders Investment Management  
 Other institutional investor (2)  
 Recent investment professionals (3)  
 Individual investors (4)

We would also like to thank the many other organisations and groups who contributed to the discussions on this topic.

## Appendix 1

# Reverse factoring

# Reverse Factoring

## What is Reverse Factoring?

Reverse factoring is a type of finance transaction akin to factoring. In a traditional factoring arrangement a business will sell its accounts receivables (i.e. invoices it has raised with buyers) to a third party (often a bank) in exchange for a significant proportion of the cash value of the invoice. Factoring has long been a method of managing working capital as it provides earlier access to cash from sales than would otherwise follow the traditional credit terms.

Reverse factoring is similar to factoring, but it is the purchaser rather than the seller who is the originator of the facility. In reverse factoring the purchaser of goods organises a facility with their bank or other finance provider. This facility allows suppliers to get their invoices factored, and receive cash at a point before the purchaser intended to pay. This type of scheme is particularly beneficial to smaller suppliers who may not have sufficient financial strength to obtain competitive factoring terms themselves.

## What is the benefit for the originator?

Broadly there are two different (although in some cases parallel) objectives from the originator for such schemes: 1) to support smaller suppliers (supplier-focused); 2) to support the originator's working capital management and financing (company-focused). Whilst these two objectives are quite different it is often difficult to assess from the available disclosure what the company's objective is.

Whilst normal payment terms might see a purchaser pay a supplier within 30 days, the switch to a reverse factoring facility might also see the payment terms increase as the facility provider will agree terms with the originator. Any increase in payment period will have the effect of improving the originator's working capital cycle.

## How prevalent is reverse factoring?

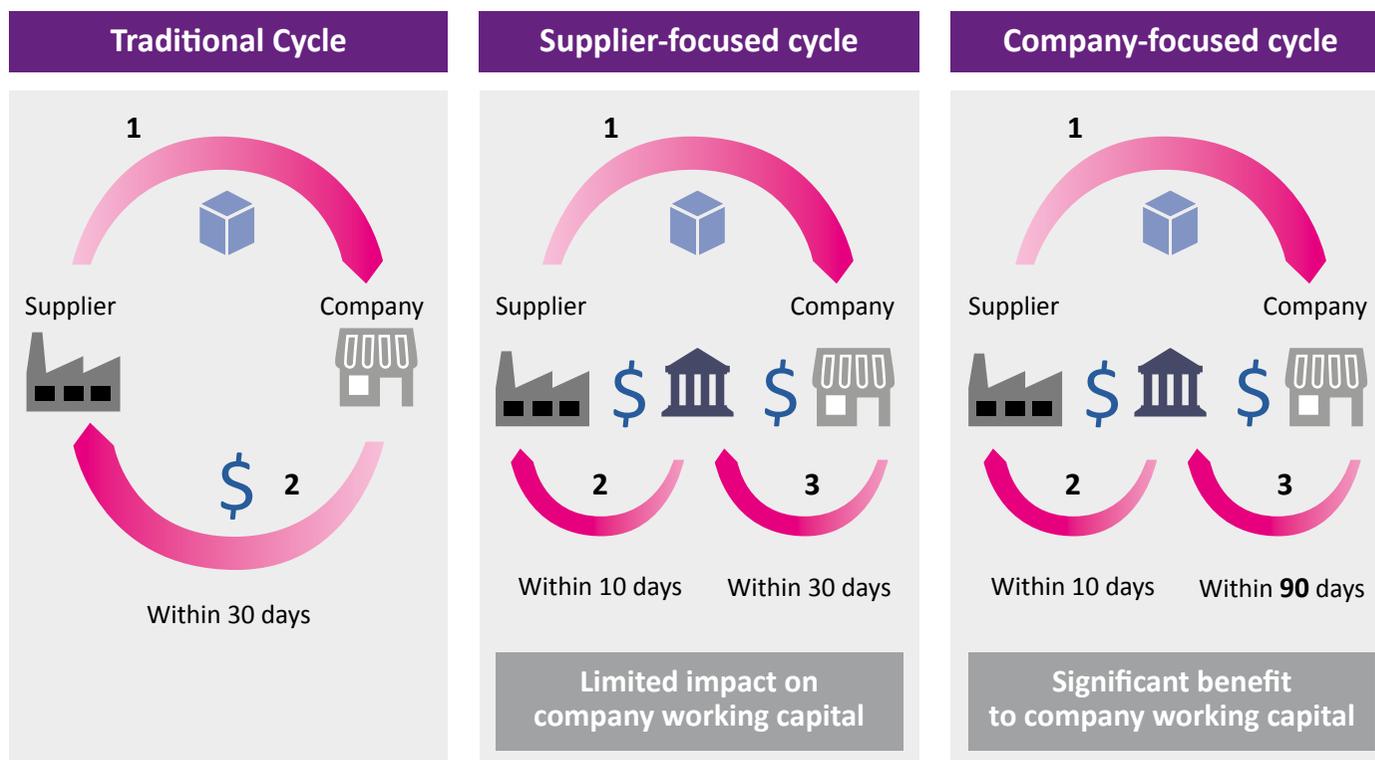
There is limited data on the amount of reverse factoring currently in place. However, the European Factoring Association estimates<sup>4</sup> that the total of factoring and

reverse factoring combined was £350bn for the UK & Ireland in 2017.

Furthermore, an analysis of the UK Government's Supplier Payment portal shows that around 6% of the companies that filed on this portal offer supply chain finance (which includes individual entities as well as subsidiaries of groups).

<sup>4</sup> <https://euf.eu.com/facts-and-figures/facts-and-figures/euf-estimates-on-eu-market.html>

### Example of reverse factoring



## Why are investors interested?

Investors support companies that are effectively managing their working capital. However, a number of high profile failures and other difficulties where working capital issues have been important, have raised questions on supplier financing schemes.

Their concern is that where (company-focused) reverse factoring is used, any curtailment of the facility might create a working capital issue for the originator, as they would need to pay their supplier to the original timetable. They would therefore not benefit from extended terms with the bank or third party facility provider (if such terms were in place). In addition there is a concern that companies can become overly reliant upon the usage (and expansion) of these facilities and the favourable impact they have on cash (in the short term). Therefore clear disclosure on usage of the facility and impact on results and financial statement balances is very important and would allow users to better understand the risks of the business.

Whilst generally investors might look to the annual report of a company to help identify issues such as reverse factoring, current levels of disclosure are generally limited. Our review across the FTSE 350 identified only a very small number of companies disclosing anything related to reverse factoring. This might reflect the relative immaterial nature of any facility but may also reflect that there is limited specific accounting guidance on the topic.

*“I want to know how much working capital comes from financing activities such as factoring... it has grown 3 or 4 times since 2007, it is concerning.” Investor*

*“This idea that small businesses could collect their invoice by the due date via a bank, well surely this means that the money is now owed to the banks... so why is it not shown as debt?” Investor*

## What the market thinks

Reverse factoring and wider supplier payments have been an area in which market interest has grown. Recent analyst reports from Barclays<sup>5</sup> and Moody's<sup>6</sup> have covered the issue, furthermore the Chartered Financial Analyst Institute (CFA) recently released an article which highlighted their concerns around reverse factoring. They noted that it was important for investors to understand the difference between the three types of reverse factoring arrangement:

- **“Good” reverse factoring**, the situation where a company uses its stronger credit rating to facilitate factoring at superior rates and terms than the supplier could achieve. This particularly benefits smaller suppliers.
- **“Bad” reverse factoring**, the situation where the company uses its power to push the supplier to factor with a provider to enable it to maximise working capital.
- **Confirming**, the situation when a company cannot persuade its supplier to extend the credit period and uses a bank or financial provider to support the gap.

In order to provide investors with information that allows them to assess these three different types of reverse factoring they advocate for an “maximum outstanding number of days” disclosure for suppliers. This disclosure, based on contractual terms including extension options, would inform them about the presence of “bad” reverse factoring and would also provide transparency to confirming arrangements, both qualitatively and quantitatively.

The full article is available on the [CFA website](#).

<sup>5</sup> Working Capital Finance: The Debt Factor - March 2018.

<sup>6</sup> Reverse Factoring is increasingly popular but can weaken liquidity at times of stress - Sept 2019.

## Accounting guidance

In a recent letter to the BEIS select committee<sup>7</sup> the FRC noted that there is limited specific guidance on reverse factoring and that the accounting and disclosure requirements depend on the specific facts and circumstances of the arrangement. However, the letter highlighted that the following standards could be considered as providing some guidance:

**IAS 39 – ‘Financial Instruments: Recognition and Measurement’ (recently replaced by IFRS9)** addresses the derecognition of financial liabilities. Its requirements are relevant in assessing the appropriate presentation of the liability arising from the arrangements. In particular, consideration must be given to whether the original “trade payable” liability is extinguished (i.e. the customer is legally released from its obligations to the supplier) or its terms amended to such an extent that its replacement with a new debt-like liability is appropriate.

Consideration of quantitative and qualitative factors, including the detailed terms of the arrangement, will be necessary when performing this assessment.

**IAS 1 – ‘Presentation of Financial Statements’** – requires that entities present separate line items on the balance sheet for trade and other payables and other financial liabilities. Additional line items are also required, where relevant, to gain an understanding of the entity's financial position – either on the face of the balance sheet or in the notes to the accounts.

These IAS 1 requirements provide a framework for determining the structure of an entity's balance sheet. Liabilities that are financing in nature are normally presented together and described as debt or financial liabilities, and liabilities that are working capital in nature are normally presented within trade and other payables.

If presentation and classification of the liability constituted a critical accounting judgement for the entity, IAS 1 would require additional disclosure.

**IAS 7 – ‘Statement of Cash flows’** requires entities to classify cash flows according to whether they arise from operating, financing or investing activities – and consistency between the statement of cash flows and the balance sheet can be expected. Therefore, the definitions of operating and financing activities might also assist entities in determining the appropriate presentation of liabilities arising from reverse factoring. The classification within the cash flow statement should reflect the substance of the arrangement which requires some judgement.

The application of the above standards may involve a high level of judgement in order to determine and reflect the substance of the arrangement, and conclusions can only be drawn with reference to the specific facts and circumstance of each individual arrangement. Whilst standards provide a framework, the FRC highlights that ultimately the overriding legal requirements in presenting the financial statements are the true and fair requirements which places an onus on companies to provide sufficient disclosure.

## Other areas of guidance include

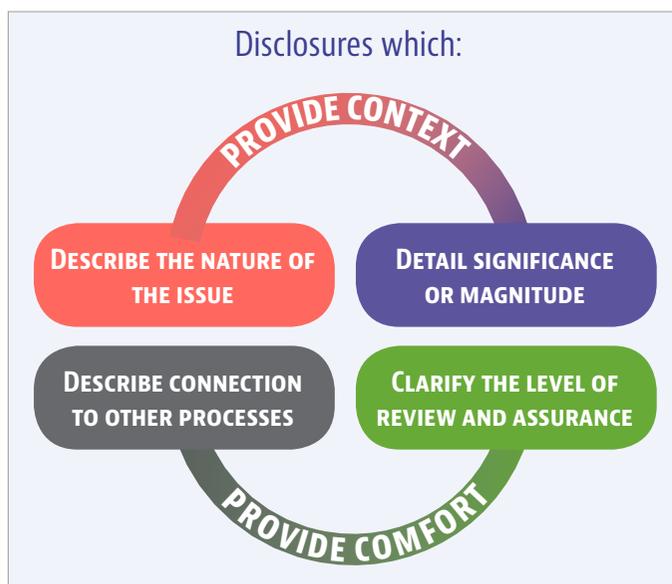
- IFRS 7 requirements around liquidity risk disclosures (IFRS 7.39), concentration risk (IFRS 7.B11F(d)) and an overarching drive to add disclosure to ensure that what is disclosed is representative (IFRS 7.35)
- IAS 8 Accounting policies
- IAS 1 Disclosures on judgements and estimates

<sup>7</sup> <https://www.parliament.uk/documents/commons-committees/work-and-pensions/Carillion%20report/Letter-from-FRC-to-Chairs-21-March-2018.pdf>

## What do investors want to know?

In the Lab's 2017 case study on WM Morrisons Supermarkets plc which covered [Supplier relationships and emerging issue reporting](#) we developed a model to describe investors' overall demands when a new issue, such as reverse factoring emerges.

Our discussions with investors on reverse factoring have shown that this is still relevant, although given the current lack of disclosure their focus at the moment is on the need for context.



### Provide context

The first stage of providing context is describing the nature of the issue. Investors want to know which companies are using reverse factoring, what type and why.

## Material by Interest

It should be noted that a lack of disclosure does not necessarily mean that there is no reverse factoring in the minds of investors, especially for companies or industries such as construction or consumer goods where it is seen as prevalent.

In response a number of companies have taken to indicating that they do not use such schemes.

*But most particularly, I'm glad to say, to formally announce, we have no factoring reverse upwards, downwards, sideways, over the top, and underneath. There was no factoring to our business.*

**Rupert C. Soames**  
**Serco Group plc**  
**Group CEO & Director**  
 (2017 full-year conference call)

Investors find such disclosure useful as it quickly closes off any further investigation.

However, investors believe that there are many companies who do use such schemes for which disclosure is not clear. One particular issue with identifying reverse factoring disclosure is a lack of consistency with naming of such schemes. Many companies will use terms such as Early Payment Scheme, Supplier payment scheme or other such name. This impedes investors' ability to quickly identify relevant disclosure when scanning and searching company reporting. Investors consider that using the term reverse factoring alongside or in conjunction with other entity specific terms would be helpful.

Where companies do identify that they are using reverse factoring schemes, the level of detail about the scheme, its purpose, and its operation are often limited. Investors would like sufficient details about the nature of the scheme, its purpose, the size of the facility and amount currently used, facilitating party and how the scheme is being reflected in the accounts. Investors highlight that where a company uses Net Debt as a key performance metric, clarity on whether reverse factoring is reflected in the number is useful.

### Provide comfort

Whilst currently the lack of information provided around reverse factoring means that investors are focused on understanding the arrangements, they also expect disclosure that provides comfort on how the arrangement is being managed and monitored.

Once understanding has been established, investors want information that conveys if there has been movement in the magnitude of the scheme, or changes in the way it operates, or is accounted for. They also want to understand the level of work undertaken by the auditors and the audit committee over the scheme and supplier payments more widely, as well as understanding how (if significant) the schemes impact on the viability of the business.

### Investors would like disclosure such as:

- Existence of scheme,
- Size,
- Current amount used and impact on working capital,
- Facilitation party and key terms,
- Links to policies/accounting judgements, and
- Process used to monitor and manage.

## Example disclosure that give context...

### Lab example disclosure

Our discussions with investors identified some examples of disclosure but these were often where the scheme was insignificant. We did not identify good examples that fully answered investors' questions in situations where reverse factoring was important for working capital (company-focused scheme). We have therefore created an example of a fuller disclosure on the next few pages that goes further than the current market practice.

This disclosure presents only extracts and would require additional disclosure to be deemed fully sufficient, for example, within the cash flow statement detail on treatment, accounting policies and IFRS 7 disclosures.

### Describe the nature of the issue

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Pg22

##### Supplier Plus Scheme

We facilitate a supplier chain financing scheme for our small and medium suppliers. This is a form of reverse factoring scheme provided by Banque de l'armee Suisse (BLAS). We have two objectives for the scheme; firstly it serves to support our smaller suppliers, giving them early access to funding, secondly it supports the wider working capital efficiency of the group.

Under the facility suppliers may opt to access payment after 30 days rather than our normal 90 day payment terms. We pay the provider of the scheme after 90 days or longer. This scheme is an important part of our management of working capital. The balance owed on the facility is £345m (2017: £295m). The total size of the facility is £500m. As the scheme has not led to significant changes in the terms of our obligation we continue to treat the amounts owed to BLAS within trade creditors (see note 12). Information about how it is factored into risks and our assessment of viability can be found on page 27. Further details about our accounting policy for reverse factoring and the judgements around the application of that policy can be found on page 111.

Risk & Viability P27

Trade and other creditors P122

Policies and judgements P111

The company highlights that it facilitates a reverse factoring scheme using clear identifiable terminology. The details of the scheme show that it has an impact on the company's own working capital.

They identify the size of the facility and clarify how they account for it.

They highlight other information that provides users with understanding.

### Describe the significance or magnitude

#### CLEAR & CONCISE REPORTING PLC

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##### Note 12 Trade and other payables

	2018	2017
	£m	£m
<b>Current:</b>		
Trade payables	676.5	675.4
Other taxation and social security	45	43
Deferred consideration	23.3	33
Accruals	3.7	23.4
	<b>748.5</b>	<b>774.8</b>
<b>Non current:</b>		
Trade payables	11.4	12.3
Deferred Consideration	1.5	1.6
	<b>12.9</b>	<b>13.9</b>
	<b>761.4</b>	<b>788.7</b>

##### Focus on: Supplier plus scheme

Within the current trade payables number is £345m (2017: £295m) related to our reverse factoring facility. The substance of the contractual terms of the scheme do not differ to those under the original contract and therefore we consider the amount owed to the bank are akin to amounts owed to the supplier.

On average we are paying the provider within 121 days. For the purposes of our Net Debt KPI we include trade creditors within the calculation.

Accounting policy P111

Strategic Report P22

They identify the size of the facility, clarify how they account for it and how it is treated for the purposes of the Net Debt KPI.

They highlight other information that provides users with understanding.

## And comfort... through disclosures which:

### Describe how the issue connects with other processes

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#### Viability assessment

As part of our assessment of longer-term viability, the board have considered a number of plausible bottom-up scenarios which could impact CCRL plc or the group as a whole (individually and in aggregate), as well as top down headroom.

#### Top Down

Bank covenants require that the groups ratio of net debt to EBITDA stays below 5.0x. As at the group's balance sheet date the ratio is 1.4x.

A combination of the bottom up scenarios would see the net debt to EBITDA ratio increase to approx. 4.5

- 1) Our long-term Swiss Rail Link contract continues to underperform and is subject to cancellation at the 2020 renewal date.
- 2) Our reverse factoring scheme is withdrawn by the provider and can not be replaced, leading to a need to fund an additional working capital requirement (31 days). We have also considered that removal of the scheme may impact the attractiveness of the company to suppliers and impact our longer-term supplier relationships.
- 3) Our negotiations with our pension trustees of our runoff subsidiary Xyl SA requires a full buyout of the scheme.

#### Bottom Up – Scenarios considered

Risks on P37

The company is clear how the reverse factoring has been considered as part of its viability assessment. This also links through to assessment of risk. This gives investors comfort that (if significant) the issue is being appropriately considered.

### Clarifies the level of review and assurance

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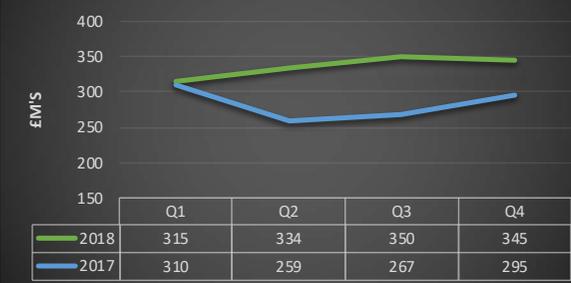
Pg48

#### Audit Committee focus

This year, as part of the audit committee's focus on supplier risk, the committee undertook a deep dive on our reverse factoring scheme. As part of this process we:

- Considered the accounting for the scheme versus other reverse factoring schemes and relevant accounting guidance and literature,
- Looked at the underlying terms of the scheme,
- Considered the use of the scheme by the company throughout the year, and

#### Supplier Plus Facility Usage



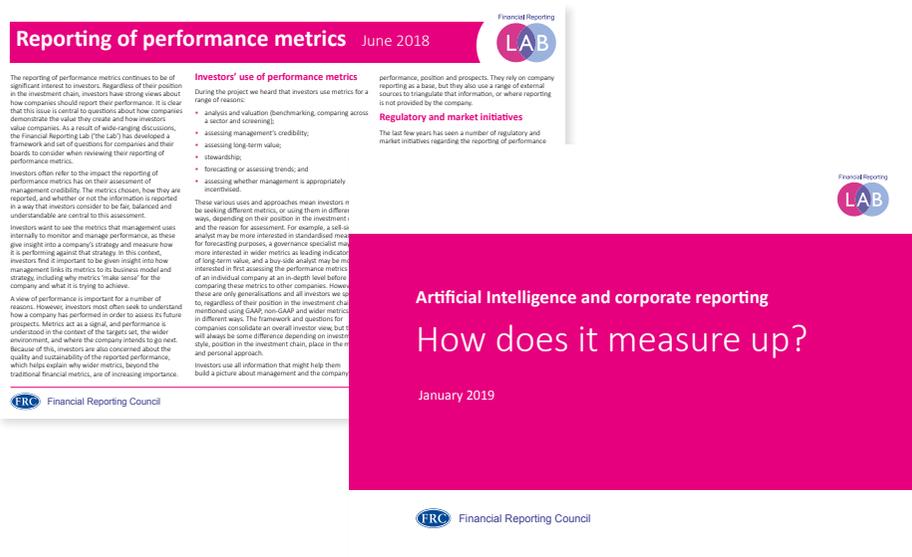
- Looked at how the scheme fitted in with our broader commitments to strong supplier relationships and our obligations under relevant regulation.

After conducting the review the committee was satisfied with the treatment and disclosure of the facility. In future periods the committee will instruct internal audit to build reviews of the scheme into the standard rotational work program.

In the Audit Committee report the company is clear how the reverse factoring has been considered and gives some clarity as to the actions taken by the committee over the accounting and disclosure for the scheme.

The Lab has published reports covering a wide range of reporting topics.

Reports include:



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