Are you doing what you can to answer investors' basic questions about debt and cash flows?

The FRC's Financial Reporting Lab (the Lab) has published three reports on debt and cash flow disclosure based on a project that obtained input from over 30 individuals from 16 investment organisations on information that matters to their decision making. The three reports highlight mainly voluntary information that is important to investors, when and why it is important, and how it is used.

The Lab's work was conducted with the help of five companies whose disclosures are used in the reports to illustrate many of the reporting practices favoured by the investment community: BT, National Grid, Royal Dutch Shell, Vodafone, and Xchanging.

The reporting practices could help companies that have significant levels of debt or plans to approach the market for funding in the future, to communicate certain key information effectively, often with only small changes to disclosure.

One analyst commented that reconciliations of net debt and information on debt terms and cash flows 'answers questions from potential sellers rather than persuades buyers'. This can be crucial when questions arise in relation to a specific company or even its peer group.

A company participant observed that companies can 'help themselves to get the Investor Relations department focused on explaining where the company is going and providing the key [strategic] messages by putting into their reports clean and crisp reconciliations' of debt and cash flow information that effectively provides the basic information.

While the project mainly identified the need for specific information to be disclosed, companies could also consider streamlining disclosure by:

- Removing additional maturity tables that present the maturity of the balance sheet amount of debt;
- On the cash flow statement, starting the operating cash flow section at operating profit, rather than repeating items below this on the income statement;
- Replacing information in narrative text with clearly labelled tables and reconciliations, and removing narrative that only repeats information already shown in tables.

The following is a selection of suggestions that, if not already doing so, companies may be able to address this year based on information already to hand. The relevance of each, and further suggestions are described in the Appendix.

Net Debt Reconciliations

- Provide a net debt reconciliation (NDR) and/or a reconciliation of net cash flows to changes in net debt. If reconciliations are already prepared internally – consider providing them externally.

Debt Terms and Maturity Tables

Are the following questions addressed?

How much debt is owed?

- Listing of debt terms by obligation – To allow investors to consider underlying currency risk and how closely the carrying amount on the balance sheet approximates the amount to be repaid, show for each significant borrowing the: principal borrowed, currency of denomination, and carrying amount on the balance sheet.
- Contractual maturity table - Show a total for principal payments and compare this to the carrying amount in the balance sheet. This also helps investors assess how close the carrying amount is to the repayment amount.

When is it due?

- Listing of debt terms by obligation - List maturity dates (month and year) for each obligation.
- Contractual maturity table - Split out maturity amounts for each of the first five years.

What is the cost of debt?

- Disclose interest rates in detail by obligation and on an aggregate, weighted average basis.

Has debt interest or principal been hedged?

- Information on how individual obligations or how the overall profile are altered can both be helpful in showing the specific impact of derivatives.

Operating Cash Flows

- Show the reconciliation of profit or loss to operating cash flows at the top of the statement of cash flows (not in the notes).
- Start the statement of cash flows with operating income or loss, or if starting from another figure, reconcile first to a subtotal for operating income or loss. This may simply mean reordering items on the statement to insert such a subtotal.
- Show the separate changes in the individual components of what is managed as working capital, and other differences between operating income or loss and operating cash flows that are specific to the business. Use descriptions that link easily to relevant items on the balance sheet and explain the nature of the differences that convert profits to cash.

Appendix

The reporting suggestions supported by the investors and analysts involved in the Lab's project are summarised in the following tables and explained further in the Lab's three reports: *Net debt reconciliations, Debt terms and maturity tables, and Operating and investing cash flows*, available at: https://frc.org.uk/Our-Work/Codes-Standards/Financial-Reporting-Lab/Published-public-reports.aspx.

Net debt reconciliations

Does your reporting:	Relevance
Net debt reconciliation Present a net debt reconciliation, showing: o cash and non-cash changes over the period? o separate movements that have different drivers, such as foreign exchange and fair value changes? Do these changes clearly tie into other aspects of reporting – the income statement, cash flows or notes?	Understanding how net debt changes over the period provides a basis for anticipating future changes. Investors generally cannot reconcile net debt themselves if a company has significant changes in debt for acquisitions, disposals, fair value or fair value hedge accounting, foreign exchange movements – or even indexation and interest accruals.
Reconciliation of changes in net cash flows to changes in net debt Present such a reconciliation?	This typically relates the cash changes in net debt to the statement of cash flows. Some companies also extend the reconciliation to link it to other key figures communicated, for example to start with EBITDA, reconciling this to the net change in net debt.
Links to the balance sheet Show how your definition of net debt links to specific amounts on the balance sheet? o Use descriptions listed on the balance sheet, and explain what is included in these if this isn't clear from the description? o Explain where any items not shown on the balance sheet can be found? o Describe any adjustments to reported amounts?	Investors will often use their own definition of net debt, but this usually starts with the company's reported information and what it manages as net debt. o Some companies adjust for the retranslation of foreign currency denominated amounts to the exchange rates achieved hedging. This gives visibility of the economic obligation after hedging. o Some companies include derivatives, but is the description clear whether (and why) it's all derivatives, or only those related to debt?
Additional insight on net debt components Note other aspects relevant to net debt? For example: o cash/investments not readily available to pay debt? o fair value or fair value hedge adjustments to debt? o derivatives related to debt principal that have not been adjusted for in the company's definition? o Cash/debt attributable to minority shareholders?	Investor definitions of net debt used in equity valuation models and comparative analysis of debt and leverage do vary, so providing clear information on items that could be considered for inclusion in (or exclusion from) net debt is helpful. Some, but not all of these items are typically available elsewhere in the financial statements, but investors are interested in more than the restrictions on cash disclosed under IFRS, for example, whether cash is needed for operational requirements, is client money, advances, or amounts subject to collateral support agreements, as well as whether it is subject to exchange controls or tax withholding.
Additional items not in net debt List other items that some investors include in net debt? Such as: o Financial investments, put options; o Net present value of operating lease obligations; o Underfunded retirement benefit obligations	
Reconciliation by component Reconcile net debt by component (versus only in the aggregate)?	This is most helpful when: o gross and net debt differ significantly; or o the definition of net debt is relatively complex. Component reconciliation helps give insight for example on underlying movements in debt and any hedging offset, useful in forecasting each component.
Average net debt Show the average net debt level for the period?	This can be helpful in demonstrating the relationship of the relevant interest cost as a % of net debt.
Placement of reconciliations in reporting Include reconciliations (NDR and net cash flows to changes in net debt) in: o Preliminary announcements? o Audited financial statements? Annual reports? o Interim reports?	NDRs provide key information for valuation and analysis. As such, they are needed as soon, and as often as, a company reports. Including these in the audited section of annual report provides additional comfort to investors, but investors would rather have 'unaudited' reconciliations than none at all.

Debt terms

Does your reporting:	Relevance
Terms by obligation Disclose terms by obligation: o principal borrowed? o currency of denomination? o maturity month and year? o interest rate?	This information is used to consider the company's sensitivity to various risks, including: o refinancing risk; and o forecasted gross interest costs. It also helps provide a 'sense check' when evaluating interest cost as a percentage of average debt. The extent of these details disclosed by companies varies, as does the method of presenting the information. This can give rise to questions and hampers analysis at a common level of detail when investigating particular risks or problems across companies.
Carrying amount and accounting method Indicate the carrying amount on the balance sheet of each significant obligation? Make clear the accounting method applied?	The carrying amount is often used in equity valuation and is generally assumed to approximate principal to be repaid. Accounting adjustments for fair value hedge accounting, fair value option adjustments, acquisition accounting, and split accounting of convertibles, can challenge this.
Bank facilities Provide the terms of bank facilities: o showing drawn and undrawn amounts? o describing the process for renewal? o explaining financial covenants, how they are calculated and the current levels met? o stating so when there are no covenants? o describing any rating triggers?	Disclosing this information could help avoid surprising the market with changes in interest or the availability of facilities, and make the significance of headroom clear. Having no financial covenants can be a significantly positive factor. Stating so provides certainty by removing any doubt. The absence of financial covenants is considered by investors as being just as material as the substance of having them.
Overall interest and currency profile o Summarise the overall interest rate and currency profile, before and after hedging? o Show the average coupon for each maturity category (for example years 1-5)?	Summarizing the overall profile can be helpful in conveying simply the contractual and economic profile of debt and risk, including changes in the profile due to refinancing or changes in floating rates. Showing average coupons for maturity categories helps anticipate changes on refinancing.

Contractual maturity tables

Does your reporting:	Relevance
Principal and interest Separate the payments of principal from those of interest?	Investors look at the risk of suspending payments of principal and the step up of interest costs upon refinancing. While principal relates to the balance sheet amount, interest is a period cost. Separately disclosing principal payment amounts helps with the assessment of how close the overall carrying amount is to the amount to be repaid. Interest is also generally a cash cost, and separate disclosure provides a sense check against forecasted interest costs.
Maturity periods Show contractual maturities for each of years 1-5?	On the question of when debt is due, disclosure of maturity month and year of each obligation, and maturity tables that show annual amounts for each of the first 5 years, provide information that is considerably more helpful than, for example, a total for years 2-5.
Maturities versus carrying amount Relate the total of contractual maturities of principal to the relevant balance sheet carrying amount? For example: o comparing principal payments to the related balance sheet amount; o also describing the differences; or o reconciling the difference, showing the significant components.	Relating information ties it together, confirming that contractual flows are compared to the correct balance sheet debt amounts. o Little difference provides comfort that the reported amount is a reasonable proxy for principal to be repaid. o Where there is a significant difference, showing the significant components enables understanding of those related to deferred issuance costs, fair value or fair value hedge accounting adjustments, or acquisition accounting, some of which investors may also adjust for.

Operating and Investing Cash Flows

Does your reporting:	Relevance
Placement of operating cash flows Show the indirect method of reconciling a profit or loss amount to operating cash flows as part of the main cash flow statement, rather than in a note?	The section on operating cash flows is a key section of the cash flow statement and it is particularly helpful to have all sections together when reports are viewed electronically.
Start of cash flow statement Start the cash flow statement with operating income or loss (or a similar subtotal on the income statement)? If this isn't permitted by a regulatory authority, does your statement reconcile first to a subtotal for operating profit, before continuing to reconcile this to operating cash flows?	Operating profit or loss provides a more relevant starting point for deriving operating cash flows under the indirect method than net profit or loss, resulting in a less circuitous statement. If the statement starts with net profit or profit before tax, reconciling this first to a subtotal for operating income or loss results in a reconciliation that is effectively from operating profit to net cash inflow from operating activities.
Differences between operating result and cash Show significant drivers of difference between operating income or loss and cash? For example, changes in individual components including: o what the company manages as its working capital; o equity accounted earnings versus the amount received in dividends; o pension contributions; and o other items specific to your business? List each using descriptions that tie easily to the amounts on the balance sheet and clearly describe the item as: o an item of income or expense; o a cash flow; or o the difference between the two?	Most investors want to see separate disclosure of changes in individual components of working capital, in order to: o understand the company's definition of working capital and the drivers of change in specific components; o develop a normalized view on cash flow; or o make adjustments or calculate subtotals of cash flow amounts. Investors often cannot calculate themselves the separate changes in balance sheet amounts if the company has, for example, foreign currency transaction or translation adjustments, acquisitions, disposals, or hedge accounting or fair value adjustments that significantly affect the related balance sheet line items.
Tax and interest List separately on the cash flow statement the cash amounts paid for income taxes and interest, and interest income received? For companies that start their cash flow statement from a profit or loss amount that includes tax or interest, this means showing removal of the income or expense amounts, and replacement with cash.	Investors indicate that gross amounts of expense and payments can 'bounce around a lot' and the components of the net change need to be isolated to understand which elements are driving the change.
Capital expenditure (Capex) Show separately capex for tangible and intangible components, indicating through disclosure the company's view on the portion attributable to maintenance and growth, where this is significant to the business?	Maintenance capex is often not considered by investors to be discretionary, whereas growth is.