



Financial Reporting Council

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# Improving the Statement of Cash Flows

A Discussion Paper prepared by staff of  
the UK Financial Reporting Council

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### The aims of this paper

- IN1 The statement of cash flows is a well-established part of financial reporting, which complements the statement of financial position and statement(s) of financial performance. It is clear that the information provided by the statement of cash flows is valuable to investors and other users of financial statements.
- IN2 Entities that prepare their financial statements in accordance with IFRS Standards are required to follow the requirements of IAS 7 ‘Statement of Cash Flows’. IAS 7 is an old standard—it was originally issued in 1992—and it would be surprising if improvements cannot be identified from the perspective of 2016. And a review may be in sight: the IASB’s project on ‘Primary Financial Statements’ is examining the purpose, structure and content of the primary financial statements, including the statement of cash flows.
- IN3 This paper presents some ideas to improve the usefulness of the statement of cash flows, which might be considered in the course of the IASB’s project. These suggestions, which are not official positions of the FRC, are intended to stimulate debate by providing an opportunity for those interested in financial reporting to comment on them: this feedback will be of interest to the IASB.
- IN4 A more ambitious approach could have been adopted, which would attempt to determine the statements or disclosures that would be the ideal supplement for the statement of financial position and the statement(s) of financial performance if a cash flow statement were not required. However, this might result in proposals that would require a radical change in practice—with unwelcome implications for both preparers and users of financial statements. Therefore, this paper adopts the more modest aim of attempting to identify possible evolutionary improvements to the statement of cash flows as currently required by IAS 7.
- IN5 The issues discussed in this paper include some of the main issues that should be considered in improving the statement of cash flows. It is not, however, a comprehensive discussion of all the relevant issues: that would require a longer and more complex paper. Respondents’ views on other issues that should be addressed are welcome.
- IN6 Some issues relating to the statement of cash flows that are being addressed, or have been recently addressed by others are not discussed in this paper. These include:
- issues that arise in the context of financial institutions.<sup>1</sup>
  - the reporting of restricted cash.<sup>2</sup>
  - the reconciliation of net debt.<sup>3</sup>

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<sup>1</sup> The European Financial Reporting Advisory Group (EFRAG) has an active project on The Statement of Cash Flows: Issues for Financial Institutions, details of which may be accessed on [www.efrag.org](http://www.efrag.org)

<sup>2</sup> At its May 2016 meeting, the IASB tentatively decided to develop, as part of a narrow scope project, proposals for the disclosure of restrictions that affect the decisions of an entity to use cash and cash equivalents (IASB Update, May 2016). Also, the Financial Accounting Standards Board of the US (FASB) issued a Proposed Accounting Standards Update ‘Statement of Cash Flows (Topic 230): Restricted Cash’ on 28 April 2016.

<sup>3</sup> The IASB issued amendments to IAS 7 that require an entity to report changes in liabilities arising from financing activities in January 2016.

- IN7 Improvements to the statement of cash flows need to be considered in the context of the financial statements as a whole. The usefulness of the financial statements is greatly enhanced if information reported in one statement can be related to information reported elsewhere. Thus, for example, the suggestion that cash flows from operating activities should be positively defined or described and reconciled to operating profit would require that the same notion of operating activities is used in both the statement(s) of financial performance and in the statement of cash flows. It is expected that linkage between the financial statements will be addressed in the IASB's 'Primary Financial Statements' project.
- IN8 Also the proliferation of disclosure requirements may lead to excessively detailed financial statements in which the most relevant information may be hard to find. The IASB's project on the Principles of Disclosure is expected to address the issue of 'disclosure overload'.
- IN9 It will therefore be necessary to reconsider any proposals developed for the statement of cash flows to take account of these considerations in the light of other proposals that are made in the IASB's work.

### **Prior work and other sources**

- IN10 Some proposals for improvements to the statement of cash flows have already been made. Notably, the IASB's Discussion Paper 'Preliminary Views on Financial Statement Presentation' of October 2008 and the staff draft of an exposure draft (developed jointly by the staffs of the IASB and the FASB) that followed in 2010 considered the statement of cash flows. Proposals made in these documents and the feedback received on them have been considered in the development of this paper, but the proposals of this paper differ in some respects from those earlier publications. For example, this paper does not suggest that a direct method statement of cash flows should be required.
- IN11 The FRC's Financial Reporting Lab has published a number of reports<sup>4</sup> that are relevant to the issues discussed in this paper. These include:
- 'Operating and investing cash flows' (November 2012);
  - 'Net debt reconciliations' (September 2012); and
  - 'Debt terms and maturity tables' (November 2012).
- IN12 In addition, academic and practitioner literature has provided valuable input to this paper. Much has also been learned from discussing the relevant issues with members of the International Forum of Accounting Standard-Setters (IFASS) and with IASB staff and Board members, and members of the IASB's advisory bodies. It should, of course, not be assumed that the views expressed in this paper are shared by any of these bodies or any individuals associated with them.
- IN13 The FRC also conducted some outreach to investors (not only those based in the UK, but also some from Germany and Japan) by means of questionnaires and meetings. This helped us understand some investor perspectives, but was not sufficiently formal to allow firm conclusions to be drawn. More input from investors and other stakeholders is required before firm proposals can be made: obtaining that input is one of the primary objectives of this paper.

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<sup>4</sup> These reports may be accessed on [www.frc.org.uk](http://www.frc.org.uk)

## Invitation to comment

1. The FRC is requesting comments by 28 February 2017 (**extended until 31 March 2017**). Comments are invited on all issues relating to possible improvements to the statement of cash flows. In particular, comments are sought on the questions below.
2. Comments are most helpful if they indicate the specific paragraphs to which they relate, contain a clear rationale and, where applicable, suggest an alternative approach.

### Section 1 The usefulness of information about cash flows

3. This section reviews the purpose of providing information about cash flows. It concludes that the main purpose is to assist users to assess liquidity and the financial structure of the entity and changes in these.
4. It also suggests that notional cash flows should not be reported in the statement of cash flows, but that transparent disclosure of non-cash transactions should be required.



#### Question 1

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

#### Question 2

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

### Section 2 The classification of cash flows

5. This section suggests that operating activities should be positively defined or described, rather than being a residual or default classification. Items should not be excluded from operating activities merely because they are unusual or non-recurring. Items that do not relate to operating activities should be reported in a separate section of the statement of cash flows.
6. The section also suggests that cash flows from operating activities should include capital expenditure, with a sub-total drawn before capital expenditure, and disclosure of the extent to which capital expenditure represents 'replacement' or 'expansion' should be encouraged.
7. The section also addresses the reporting of interest, and suggests that all cash flows in respect of financing liabilities should be reported in the financing category of the cash flow statement.
8. The discussion in this section also suggests that cash flows relating to tax should be reported in a separate section of the statement of cash flows.

**Question 3**

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

**Question 4**

Do you agree that capital expenditure should be reported within operating activities rather than as an investing activity, with sub-total drawn before capital expenditure, and disclosure of the extent to which capital expenditure represents 'replacement' or 'expansion'?

**Question 5**

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

**Question 6**

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

**Section 3 Cash equivalents and the management of liquid resources**

9. This section suggests that the statement of cash flows should be required to report inflows and outflows of cash, rather than cash and cash equivalents, and the statement of cash flows should contain a separate section that reports cash flows relating to the management of liquid resources.
10. It is also suggested that the net presentation of cash flows (other than those relating to operating activities) should be permitted only for instruments of the same class.

**Question 7**

In your view, should the statement of cash flows report flows of cash or of cash and cash equivalents? How, in your view, should cash and/or cash equivalents be defined, and why?

**Question 8**

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

**Section 4 Reconciliation of operating activities**

11. This section suggests that a reconciliation of cash flows from operating activities and operating profit should be required in all cases, and not only where an indirect method cash flow statement is presented. Because the amounts reported in the reconciliation are not cash flows, it is suggested that the reconciliation should not be reported within the statement of cash flows, but as a supplementary note.

**Question 9**

In your view, is it appropriate to require the presentation of a reconciliation of operating activities in all cases, and to prohibit presenting it within the statement of cash flows?

**Section 5 Direct or indirect method?**

12. It is suggested in this section that the direct method cash flow statement should neither be prohibited nor required, but that an accounting standard should identify particularly significant components of cash flows from operating activities and require disclosure either of the amounts of such components or of changes in related working capital items.

**Question 10**

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

**Question 11**

Which components of cash flows from operating activities should an accounting standard identify as particularly significant, and why? How should standard-setters decide whether to require disclosure of the amount of such components or of changes in related working capital items?

13. Information on how to submit comments and the FRC's policy in relation to responses is set out on page 38.

# 1 The usefulness of information about cash flows

## **Overview of this section**

*This section does not make any specific suggestions, but lays the foundation for the subsequent parts of this paper. It reviews the possible objectives of information about cash flows, and concludes that the main purpose of such information is to assist users to assess liquidity, and the financial structure of the entity and changes in it. This requires information on where the cash has come from and where it has gone.*

*The importance of information about management of working capital (usually reported in the reconciliation of a measure of profit to cash flows) is noted.*

*Also reviewed is the notion that the primary purpose of the statement of cash flows should be to report a measure of performance: it concludes that while cash flow information can enhance users' understanding of performance, providing a measure of performance should not be its main focus. However, it would be regrettable if any changes deprived users of information that they consider useful.*

## **Main suggestions made in this section (paragraphs 1.23–1.33)**

*Notional cash flows should not be reported in any section of the statement of cash flows. However, transparent disclosure of non-cash transactions should be required.*

1.1 IAS 7 notes: 'The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation'. It is to assist in this evaluation that it requires information about 'the historical changes in cash and cash equivalents'—in other words an account of where the cash has come from and where it has gone.

1.2 The IASB's *Conceptual Framework* notes (in paragraph OB20):

*Information about a reporting entity's cash flows during a period also helps users to assess the entity's ability to generate future net cash inflows. It indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance.*

1.3 The following more specific uses for information about cash are discussed in the following paragraphs:

- (i) To assess liquidity—that is to assess whether the entity is likely to generate sufficient cash to meet its liabilities as they fall due. This is more important than merely assessing the risk that the entity is likely to face bankruptcy, for if the entity can generate more cash than is required to meet its commitments, the excess can be used to provide further value for shareholders, either by new investments or by dividends.
- (ii) An assessment of the management of working capital. This is one aspect of an assessment of how efficiently the resources of the entity have been managed, which responds to the need for financial statements to assist an assessment of stewardship.

- (iii) To derive a measure of performance, such as ‘free cash flow’. A performance measure may be useful as an input to valuation (entity value can be estimated as the present value of future free cash flow). Such performance measures are also useful to users in filtering a population: for example, an investor may wish to identify the companies within a sector that have the most significant growth in a performance measure in order to concentrate further analysis on those companies.

## Liquidity

1.4 The US Securities and Exchange Commission has helpfully pointed out:

*Cash flow statements report a company’s inflows and outflows of cash. This is important because a company needs to have enough cash on hand to pay its expenses and purchase assets. While an income statement can tell you whether a company made a profit, a cash flow statement can tell you whether the company generated cash.*<sup>5</sup>

1.5 Differences between profitability and liquidity may arise because:

- (i) Profits are not represented by cash. This may happen, for example, where profits include the upward revaluation of assets, or where revenue is recognised before the customer pays, for example on a long-term contract.
- (ii) Profits are struck after deducting non-cash expenses, for example depreciation, share-based remuneration and provisions for future expenses.
- (iii) Cash generated from profitable trading is reinvested in assets other than cash, perhaps including highly illiquid assets.

1.6 Information on liquidity is reported in the balance sheet (statement of financial position). Because that statement reports the amount of cash and other assets and liabilities, it should assist an evaluation of whether the entity is able to meet its liabilities when they fall due. As comparative amounts are provided it is also possible to assess the extent to which that position has changed in the reporting period.

1.7 However, a cash flow statement can enhance a user’s understanding of liquidity and changes in liquidity by:

- focussing attention on the net change in cash; and
- highlighting the reasons for changes in the cash position, for example, whether it is due to cash generated (or consumed) by operations, or raising (or repaying) borrowing and other sources of finance, or from returns received from (acquisitions of) new investment.

1.8 Evidence from outreach confirms that investors see information on liquidity as one of the most important aspects of cash flow information. This may affect their views of the financial risk to which an entity is subject, and the entity’s ability to service its debts, or generate cash surpluses that the entity can invest in pursuit of further returns, or pay to shareholders.

1.9 Because a cash flow statement can provide a complete summary of the changes in cash—where the cash has come from, and where it has gone—it is an important means of providing information on liquidity.

1.10 But the cash flow statement that reports where the cash has come from and gone can provide more than information on liquidity, especially if supplemented by useful disclosures (for example, a reconciliation of debt). It can assist users to evaluate the

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<sup>5</sup> *Beginners’ Guide to Financial Statements* <http://www.sec.gov/investor/pubs/begfinstmtguide.htm> (accessed 4 October 2016).

financial structure of the entity and changes in it. This enhances their understanding of the ability of the entity to manage its resources, its sources of finance and how they have been used, and its exposure to risks.

## Management of working capital

- 1.11 Disclosures usually made in the cash flow statement also highlight information that assist an assessment of how efficiently the resources of the entity have been managed. Changes in working capital and their relationship to other amounts reported in the period may highlight, for example, whether an increase in accounts receivable is proportionate to an increase in sales—if not, it might be, for example, that the entity's ability to collect receivables has deteriorated. Again, evidence from outreach confirms that management of working capital is of interest to investors.
- 1.12 Information about changes in working capital is usually reported by a reconciliation of a measure of profit to cash flows that is presented in the statement of cash flows. The presentation of that reconciliation is discussed in Section 4.

## A performance measure?

- 1.13 Assessments of the performance of an entity often focus on cash flow metrics, such as free cash flow. Providing a measure of performance is therefore one of the most obvious potential uses of cash flow information. However, there are a number of reasons why this may not be its paramount purpose.
- 1.14 One might suppose that accruals information might provide a better insight into performance than information on cash. It has been cogently observed:

*Accruals have long been used to measure the ultimate cash consequences of business activities, and allocations have been used to assign resource costs to periods of resource use. The objective of departing from cash-basis accounting is, paradoxically, to improve the measurement of a firm's cash generating ability. Accruals measure cash consequences, and allocations even out lumpy cash expenditure or commitments.*<sup>6</sup>

- 1.15 The IASB's *Conceptual Framework* makes a slightly lengthier case for the superiority of accruals information (paragraph OB17):

*Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.*

- 1.16 Some discussions of the use of free cash flow (FCF) suggest that it should be derived from accruals information. James A Ohlson, for example, says:<sup>7</sup>

*Many analysts think that if they want to estimate a company's FCF, they need to look at the cash flow statements; however, the cash flow statements are not needed. The best*

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<sup>6</sup> Thomas H Beechy (1983) *Accounting for Corporate Income Taxes: Conceptual Considerations and Empirical Analysis* Canadian Institute of Chartered Accountants, page 128.

<sup>7</sup> *Cash Flow Analysis and Equity Valuation*, reprinted as Chapter 16 of *Valuation Techniques: Discounted Cash Flow, Earnings Quality, Measures of Value Added, and Real Options*, edited by David T Larrabee and Jason A Voss. Wiley, 2013. Page 354.

*answer to the problem of how to estimate the current FCF is to define FCF as NOPAT [net operating profit after taxes] minus the change in the book value of invested capital.*

Stephen H Penman advocates a similar approach.<sup>8</sup>

- 1.17 This suggests that the cash flow statement is not required to provide a performance measure, such as free cash flow. However, it is clear that cash flow information is valuable by providing an alternative perspective on performance, and in particular by relating the results of operations to cash flows. This is discussed further in Section 4.
- 1.18 The FASB, in the development of FAS 95 'Statement of Cash Flows' concluded that 'reporting cash flow per share would falsely imply that cash flow, or some component of it, is a possible alternative to earnings per share as a measure of performance' (paragraph 122). It noted that 'net cash flow from operating activities is not comparable to net income because recovery of capital is not a factor in its calculation, and net cash flow from operating activities includes both returns on and returns of investment' (paragraph 124). FAS 95 therefore prohibits the reporting of an amount of cash flow per share.
- 1.19 One of the dissenting FASB members (Raymond C Lauver) suggested that, in spite of statements to the contrary, FAS 95 attempts to establish cash flow from operating activities as an alternative performance indicator. He objected in particular to FAS 95's observation that 'Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income'. Some of the consequences of that are:
- (i) Cash flows from operating activities are after interest and tax; and
  - (ii) Non-operating items that are included in net income are also included in cash flow from operating activities.

These issues are considered later in this paper.<sup>9</sup>

- 1.20 In summary:
- accruals information provides superior information on performance than information about cash flows;
  - at least in the opinion of some, the best measure of free cash flow can be derived from accruals information;
  - cash flow information cannot be considered as a measure of performance as it includes both returns on and returns of investment.
- 1.21 It is therefore reasonable to be wary of the idea that a main focus of improvements to information about cash flow is to provide a measure of performance. The cash flow statement should not be simply a restatement of the statement(s) of financial performance on a cash basis rather than an accruals basis.
- 1.22 However, information about cash flow can assist users in their understanding of performance as it provides a different perspective on an entity's operating activities. By explaining the relationship between accruals-based performance measures and the entity's cash generation, cash flow information provides an insight into the quality of performance. It is also important to be aware that some investors may use metrics

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<sup>8</sup> *Financial Statement Analysis and Security Valuation*, Fifth Edition 2012, Chapter 10.

<sup>9</sup> A thoughtful analysis of whether the objective of the operating section of the Statement of Cash Flows is to provide a cash-basis measurement of (i) the entity's profit or loss (that is, net income); or (ii) the entity's operating income is given in the IASB staff paper prepared for the IFRS Interpretations Committee, which is available at <http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/March/AP07-IAS-7.pdf>

derived from cash flow information, and it would be regrettable if any changes deprived them of information that they consider useful.

### **Should the cash flow statement include notional cash flows?**

- 1.23 The above discussion has highlighted that a cash flow statement can enhance a user's understanding of liquidity and changes in liquidity by focussing attention on the net change in cash. In some cases, however, reporting simply cash inflows and outflows may seem to be incomplete and perhaps even misleading, especially where means of financing other than conventional borrowings are used. It is sometimes suggested that the cash flow statement should be adjusted to complete the depiction of the entity's activities and ensure comparability with other entities. To achieve this, the cash flow statement would report not only inflows and outflows of cash, but also other amounts that are regarded as economically similar: these might fairly be described as 'notional cash flows'.
- 1.24 For example, the cash flow statement of an entity that borrows to finance the purchase of a new machine will report a cash inflow from financing activities and a cash outflow for the purchase of the machine.<sup>10</sup> Some would suggest that an economically similar position might be achieved if the entity had entered into a lease for the machine (which is the essential rationale of IFRS 16 'Leases'). Because the economic effect is similar, they might suggest that the cash flow statement of a lessee should be adjusted to reflect a notional cash inflow from financing and a cash outflow to record the acquisition of a right-of-use asset.
- 1.25 Comparability between entities that finance their assets by borrowing and leasing is one of the objectives of IFRS 16. That standard, however, is primarily concerned with the provision of information under the accruals basis, in the statement(s) of financial performance and the statement of financial position. But it is clear that the economic position of a purchaser and a lessee are different in their use of, and requirements for, cash: the purchaser needs to pay cash for its machinery, whilst the lessee is able to make payments over the term of the lease. If the statement of cash flows is to provide information on cash inflows and outflows, it should highlight rather than obscure that difference. It would therefore not be appropriate to include notional cash flows in the cash flow statement of a lessee to reflect the inception of a lease.
- 1.26 Another example where transactions that may seem economically similar give rise to different cash flows is provided by factoring. An entity that factors its receivables will report a cash inflow (from the factor) earlier than a similar entity that extends credit to its customers. Some might suggest that the statement of cash flows should include notional cash flows to promote comparability between entities that factor their debts and those that do not. However, this would be contrary to the purpose of the statement—providing information on cash flows, which differs depending on whether debts are factored or not. An alternative approach is outlined below.
- 1.27 Accounting standards prescribe the circumstances in which the supplier should either (i) derecognise the receivables; or (ii) continue to recognise the receivables and record a liability to the factor. If the factoring arrangement is appropriately regarded as a sale for the purpose of the accruals-based financial statements, it would be consistent to classify the cash received from the factor as a cash flow from operating activities, as it essentially replaces the cash consideration that is paid by the customer.<sup>11</sup> On the other

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<sup>10</sup> The classification of cash flows in relation to property, plant and equipment is discussed in Section 2, at paragraphs 2.6–2.19.

<sup>11</sup> In some instances, a factoring arrangement may be treated as a sale for financial reporting purposes but customers continue to pay the entity, which receives the cash as agent for the factor to whom it is paid over. Such cash flows should not be reported in the statement of cash flows, as transactions that an entity undertakes as an agent of another are not reflected in financial statements.

hand, if the factoring arrangement is treated for financial reporting purposes as a financing arrangement, the cash received from the factor would be reported in the statement of cash flows as an inflow from financing activities. In this case, the entity's receipts from customers would be reported as cash inflows from operating activities and, of course, payments to the factor should be reported as cash outflows relating to financing activities. This reporting appropriately reflects the impact on the cash flows of various factoring arrangements: it would not be appropriate to include notional cash flows in the statement of cash flows in order to promote comparability with entities whose transactions may be somewhat similar but have different cash consequences.

- 1.28 Reverse factoring is a variant of more established factoring arrangements under which the liability to the factor is that of the purchaser and not the supplier. The supplier will receive cash from the factor: as with more conventional factoring this should be reported as a cash flow from operating activities as it essentially replaces the cash consideration that is payable by the customer. Under such an arrangement, the purchaser incurs a liability—typically when goods and services are received—for no cash consideration: this is satisfied by the payment of cash, which should be reported in the statement of cash flows in the period in which it takes place.
- 1.29 The classification of cash outflows relating to the transactions discussed above may be doubtful. In particular:
- How should a lessee classify cash flows that represent payments under a lease liability?
  - How should a customer classify cash flows relating to payments made to a factor under a reverse factoring arrangement?
- 1.30 Some might argue that such cash flows must be reported within cash flow from operating activities: omitting them would imply that operating activities do not require cash expenditure on leased assets or for the goods and services supplied under reverse factoring arrangements. Others might suggest that, to the extent that lease finance and reverse factoring arrangements have been used in the reporting period, that is precisely the case: the assets required for operating activities have been acquired for no cash consideration.
- 1.31 One approach would be to anchor the classification of the cash flows on that prescribed by other accounting standards for the presentation of the related liabilities in the statement of financial position. Where the liabilities are presented as financing arrangements, cash flows to repay them would be classified within financing activities: conversely if (as might more often be the case with liabilities under reverse factoring arrangements) the liability is presented as a trade creditor, cash flows would be classified within cash flows from operating activities.
- 1.32 The point remains that cash flow information alone may provide an incomplete portrayal of an entity's activities. It is therefore desirable for an accounting standard to require entities to ensure that non-cash transactions are transparently reported in financial statements. IAS 7 presently contains such a requirement (paragraphs 43 & 44), although that is limited to investing and financing transactions. There seems to be a case for extending this requirement to all non-cash transactions, including those related to operating activities. This might not impose a large additional burden if the suggestion, discussed in Section 4 below, that a reconciliation between cash flow and profit from operating activities is required. The importance that investors attach to the disclosure of non-cash transactions was highlighted in the Financial Reporting Lab's report 'Operating and investing cash flows'.<sup>12</sup>

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<sup>12</sup> *Operating and investing cash flows* <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Financial-Reporting-Lab-project-report-Operating-a.pdf> (accessed 10 October 2016).

- 1.33 Some would suggest that information on non-cash transactions and other events reported in the accruals-based financial statements should be presented as a separate column alongside the cash flow statement so that the aggregate of the two columns explains the total change in the amounts reported in the statement of financial position.

## 2 The classification of cash flows

### **Main suggestions made in this section**

*Operating activities should be positively defined or described (perhaps as including transactions with customers, employees and suppliers) rather than being a residual or default classification.*

*It should be clear that items should not be excluded from operating activities merely because they are unusual or non-recurring. However, these items should be separately disclosed.*

*Items that do not relate to operating activities (or another defined section of the cash flow statement) should be reported in a separate section of the cash flow statement.*

*Cash outflows to acquire property, plant and equipment should be reported as a cash outflow from operating activities. As such outflows are likely to be volatile, a sub-total of cash generated from operating activities before capital expenditure should be disclosed.*

*Entities should be encouraged to disclose the extent to which expenditure on property, plant and equipment represents 'replacement' or 'expansion'.*

*Cash flows on financing liabilities (including the payment of interest) should be reported in the financing category of the cash flow statement. Cash received from customers (including any amount treated as interest income in the statement of profit or loss) should be reported within cash flow from operating activities.*

*Cash flows relating to tax should be reported in a separate section of the statement of cash flows.*

- 2.1 IAS 7 requires that the cash flows are classified into operating, investing and financing activities. This classification has strong intuitive appeal, and seems to work reasonably well in practice. This section discusses some of the ways in which the classification could be improved. The specific areas that are discussed are:
- The definition of cash flow from operating activities (paragraphs 2.2–2.5);
  - Property, plant and equipment (paragraphs 2.6–2.19);
  - Interest and dividends (paragraphs 2.20–2.34); and
  - Taxation (paragraphs 2.35–2.39).

### **The definition of cash flows from operating activities**

- 2.2 The importance of information on cash flows from operating activities is clear. Operating activities are generally more persistent than other activities and are therefore central to an assessment of the entity's prospects of future cash flows.
- 2.3 IAS 7 defines operating activities as 'the principal revenue-producing activities of the entity and other activities that are not investing or financing activities' (paragraph 6; emphasis added). One of the consequences of that definition is that 'operating activities' becomes the default category, i.e. it includes anything, irrespective of its nature, that does not meet the definition of the other categories. If operating activities are important, it is possible to feel some discomfort with this. It would seem preferable for only items that are operating to be reported as such—not operating + hard to classify items. A

superior approach would be to require items that are non-operating (and do not fall within one of the other defined categories) to be reported in an additional, separate, section of the statement of cash flows. One might expect, for example, that many would find it useful to distinguish cash outflows relating to the defence of a hostile takeover approach from operating cash flows.

- 2.4 To meet this aspiration it would be necessary to delete the reference in IAS 7's definition to 'and other activities that are not investing or financing activities' and expand on 'the principal revenue-producing activities' of the entity. It might be explained that 'operating activities' would typically include transactions with customers, employees and suppliers. This would be consistent with the IASB's observation in its Exposure Draft *Conceptual Framework for Financial Reporting* (ED/2015/3) that, in classifying items in the financial statements, their role or function within an entity's business activities is a relevant consideration. It should be clear that items should not be excluded from 'operating activities' simply because they are unusual or non-recurring.
- 2.5 As mentioned in the Introduction to this paper, it would be important for the same notion of operating activities to be used for both the statement of cash flows and the statement(s) of financial performance.

### **Property, plant and equipment**

- 2.6 Under IAS 7, the purchase of property, plant and equipment is reported as an investing activity. However, because such purchases are required to support operating activities, this requirement appears anomalous. It gives the impression that an entity's operating activities can be carried out without requiring cash outflows to acquire fixed assets, which is not usually the case if such assets are significant.
- 2.7 It would be more logical for the purchase of property, plant and equipment to be reported as an operating cash flow, as proposed in the 2010 staff draft of an exposure draft 'Financial Statement Presentation'. This would accord with the practice of some users who subtract investing cash flows from cash generated from operations to derive a measure of 'free cash flow'.
- 2.8 The effect of including the purchase of property, plant and equipment in operating activities is effectively to substitute the current cost of such assets for historical cost depreciation. It might be reasoned that it would equal depreciation on a current replacement cost basis. This is true—but only if it is assumed that the entity's business is not growing (nor shrinking) and that capital expenditure is constant in each period. These are large assumptions that are unlikely to be fulfilled often in practice.
- 2.9 Perhaps, ideally, a distinction should be made between:
- (i) 'replacement' capital expenditure that maintains existing capacity; and
  - (ii) 'expansion' capital expenditure that expands capacity, or extends the activities of the entity.
- 2.10 The value attached by investors to this distinction is evidenced by the Financial Reporting Lab's report 'Operating and investing cash flows'.
- 2.11 It would seem logical, and has been suggested in outreach with investors, that replacement capital expenditure should be reported as a cash outflow from operating activities, whilst that relating to expansion should be reported as an investing activity.
- 2.12 However, it is apparent that such a distinction may be difficult to apply in practice. Because of changes in technology and business needs, replacement assets are rarely identical to those that are retired. A new production line may provide greater capacity

and lower operating costs than the one it replaces. Arbitrariness and subjectivity in allocation would therefore be inevitable. Some may take the view that an inherently arbitrary allocation should not be used in the financial statements, as it lacks the qualitative characteristic of verifiability.

- 2.13 The possible solutions to this issue would be:
- (a) to require preparers to make the distinction between ‘replacement’ and ‘expansion’ capital expenditure and present them separately in the statement of cash flows as operating and investing activities respectively. A requirement to disclose the basis of allocation could be made; or
  - (b) to require all capital expenditure to be reported as a cash outflow from operating activities, and encourage separate disclosure of the two classes of capital expenditure. (IAS 7 already encourages such disclosure (paragraph 50(c)).
- 2.14 If separate presentation were required, there would seem to be incentives to classify expenditure as ‘expansion’. This would increase the reported cash generated from operating activities, and also increase the amount reported as investment—which might be seen as an indication of management’s confidence in future profitability. It might therefore be thought desirable to set a high hurdle for classifying expenditure as expansion in order to counter this temptation. It might be specified, for example, that:
- (i) expenditure should be classified wholly as replacement even if the replacement asset is economically superior to that which it replaces—for example, by providing lower operating costs, or greater capacity.
  - (ii) expenditure on property, plant and equipment should be classified as investing only if it relates to the expansion of the entity’s activities to a new line of business.
  - (iii) the basis for classifying expenditure as investing should be disclosed.
- 2.15 But it is questionable how effective such an approach would be. It would add complexity, and might prompt debate and demands for interpretation. On balance, the better approach seems to be to require all capital expenditure to be reported as a cash outflow from operating activities, with encouragement of separate disclosure of the two classes of capital expenditure.
- 2.16 Operating activities are often more persistent than other activities. However, expenditure on property, plant and equipment will often be lumpier than other components of operating activities. For this reason it should be separately disclosed.
- 2.17 If expenditure on property, plant and equipment were separately disclosed as a component of cash generated from operating activities, it would be natural to disclose an amount of ‘cash generated from operating activities before capital expenditure’. As is discussed below, the suggestions in this paper are that interest on financing liabilities and tax should both be excluded from cash flow from operating activities. It would seem that a consequence of this approach would be that ‘cash generated from operating activities before capital expenditure’ would resemble EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation), with cash substituted for earnings.<sup>13</sup>
- 2.18 An issue related to the reporting of cash flows for the acquisition of property, plant and equipment, arises in the presentation of business combinations. Cash consideration for the acquisition of a business would presumably be reported as a cash outflow from investing activities, and separately disclosed. However, sometimes there may be little substantive difference between buying a business and purchasing assets. IFRS 3

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<sup>13</sup> This assumes that ‘earnings’ includes only operating items, interest and tax. Non-cash operating items (e.g. share-based compensation expense) would be excluded from cash generated from operating activities before capital expenditure.

'Business Combinations' addresses whether a transaction is a business combination or the acquisition of assets and liabilities.<sup>14</sup> It would seem confusing and unnecessary to use a different distinction for the purposes of cash flow information.

- 2.19 While the above discussion has focussed on the reporting of cash flows to purchase property, plant and equipment, the requirements of IAS 7 to report such flows within investing activities also apply to the purchase of intangibles and other long-term assets. Cash receipts from the sale of such assets are also included in investing activities. The considerations set out above would apply equally to such cash flows, so they would also be reported within cash flow from operating activities. The Financial Reporting Lab's report 'Operating and investing cash flows' noted that investors would value disclosure of the gross amounts of expenditure and sales, and separate disclosure of amounts for tangible and intangible assets.

## Interest and dividends

- 2.20 IAS 7 requires an entity to disclose separately cash flows from interest and dividends received and paid, and classify them consistently within the categories of operating, investing or financing. The flexibility this allows can be expected to lead diversity in practice and hence a loss of comparability.
- 2.21 Interestingly, the Illustrative Examples that accompany IAS 7 include an amount captioned 'Cash generated from operations' that excludes interest and tax paid: these items are then deducted to arrive at a total for 'Net cash from operating activities'.
- 2.22 FAS 95 'Statement of Cash Flows' requires all cash flows of interest received and paid and dividends received to be reported within operating activities—a treatment to which three (of the then seven) FASB members dissented. The options allowed by IAS 7 and the divergence of views among FASB members shows that the classification of such cash flows is a difficult issue.
- 2.23 The difficulties may be illustrated by considering the example of zero coupon debt. This requires only one cash flow, which is paid on maturity. Therefore, in accounting periods while the debt is in issue no cash flows are reported. In the period in which it matures a single cash flow may be split into an amount representing interest, reported as a cash outflow from operating activities, and an amount representing repayment of principal, reported as a cash flow relating to financing activities.<sup>15</sup> At least one writer<sup>16</sup> has commended this approach, and also suggested that the cash flow statement should be adjusted to report the imputed interest for the periods in which zero coupon debt is in issue. But while imputing interest is necessary and appropriate for the statement of profit or loss, as it is prepared on an accruals basis it is inappropriate for the statement of cash flows, which should report only flows of cash.
- 2.24 A loan may be thought of as simply an exchange in which cash is received on issue, and in return for which cash repayments are promised. The cash repayments may be characterised from a legal perspective as payments of principal or interest and this may be important in some circumstances, such as in the event of default. However, such a characterisation does not seem relevant for the cash flow statement: all cash payments to lenders are simply fulfilment of contractual promises made to the holders of the debt, and should therefore be classified as financing cash outflows.

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<sup>14</sup> In June 2016 the IASB issued an Exposure Draft 'Definition of a Business and Accounting for Previously Held Interests' (ED/2016/1) that proposes to clarify the distinction between an acquisition of a business and an acquisition of a group of assets.

<sup>15</sup> The FASB has recently proposed that this is the approach to be adopted under US GAAP: (Proposed Accounting Standards Update: Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. January 29, 2016.

<sup>16</sup> Standard & Poor's Rating Services *Ratings Direct: The Statement of Cash Flows—Comparing the Incomparable* February 2014.

- 2.25 It may be questioned whether the concept of interest is relevant for the purposes of reporting cash flow information. The concept of interest is necessary to identify whether an amount represents a return *of* capital or a return *on* capital, which is fundamental to the preparation of accrual information. But it is unnecessary and misleading in the context of cash flow. Putting this another way: for accruals accounting it is necessary to determine whether a cash flow represents a change in assets and liabilities (for example a reduction in cash and an equal reduction in debt) or income or expense: this question does not arise in preparing a cash flow statement. Instead, the question is in which category the cash flow should be presented.
- 2.26 In the case of zero coupon debt only one cash outflow is reported in the cash flow statement—and that arises in the period in which the debt matures. The analysis suggests that this outflow might be described in the cash flow statement as a ‘payment to providers of debt finance’. This is representationally faithful of the actual cash flows relating to the debt. Some, however, may consider that it would be informative to disclose separately the amounts that relate to interest and principal.
- 2.27 Perhaps a more difficult situation is that of the sale of an asset on credit terms that are sufficiently long term that discounting is material. As with zero coupon debt, it is tempting to split the cash flow, with the interest element reported in investing activities and the amount equivalent to the cash price of the goods reported as a cash inflow from operating activities. But the cash flow statement should report actual, not imputed, cash flows.
- 2.28 Three members of the FASB who dissented from the adoption of FAS 95 expressed the view that the sale of goods for deferred payment should be regarded as a non-cash investing activity, and receipts from the financial instrument received should be reported as cash inflows from investing. This approach would seem to make sense in the unusual case in which an entity accepted an investment instead of a cash consideration, but gives a counter-intuitive result where sales are routinely made on deferred terms: an entity that makes all its sales on deferred terms would not report any cash collected from customers within cash flow from operating activities.
- 2.29 It would seem reasonable to distinguish:
- (a) the sale of assets on normal credit terms, giving rise to a customer receivable; and
  - (b) the sale of assets in exchange for a separate financial asset. Such an asset would not normally represent a claim on the purchaser but on a third party and would be classified by the seller as an investment. (It is not intended to suggest that transactions of this kind are common.)
- 2.30 Using this distinction, cash inflows relating to customer receivables (category (a)) would be reported within cash flows from operating activities. Cash flows relating to a financial asset received in exchange for an asset (category (b)) would be reported as relating to investing activities.
- 2.31 Similarly, when an operating asset is acquired on credit terms, a trade payable would be recognised, and cash payments in respect of that payable would be reported within cash flows from operating activities. In contrast, if the acquisition of an operating asset were financed by debt raised from a third party the following cash flows would be reported:
- (i) receipt of loan proceeds—cash inflow within financing activities;
  - (ii) acquisition of the asset for cash—cash outflow within operating activities; and
  - (iii) payments to loan creditor—cash outflow within financing activities.
- 2.32 Other items for example, provisions under IAS 37, may be discounted and hence give rise to interest expense in the statement of profit and loss. However, as argued above,

'interest' is not a concept that applies to the statement of cash flows. If the provision relates to operating activities—which is likely to be the case, for example, if it relates to warranty obligations or environmental obligations arising from operations—then cash flows should be reported as relating to operating activities.

- 2.33 IAS 7 notes that dividends paid may be classified as a component of cash flows from operating activities 'in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows'. This seems somewhat unconvincing. Dividends are clearly paid to providers of capital, and should therefore be reported as financing cash flows, as should other payments (such as those relating to a share repurchase) made to owners in their capacity as owners. Dividends and other payments received from investments should be reported as cash flows from investing activities.
- 2.34 As with all the suggestions made in this paper, it would be important to ensure that the amounts reported can be related to items reported in the statement of financial position and the statement(s) of financial performance.

## **Taxation**

- 2.35 IAS 7 (paragraph 35) requires cash flows arising from taxes on income to be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. This is consistent with:
- (i) IAS 7's definition of 'operating activities' which, makes it the default category to which all cash flows that do not relate to investing and financing are assigned; and
  - (ii) the view that cash flow from operating activities should be analogous to earnings, which is, of course, after tax.

The views presented in this paper are inconsistent with both these points.

- 2.36 As noted in paragraph 2.21, the Illustrative Examples that accompany IAS 7 exclude taxes paid from 'Cash generated from operations', but include them in 'Net cash from operating activities'.
- 2.37 The IASB's staff draft of an exposure draft 'Financial Statement Presentation' of July 2010 proposed that all cash flows relating to income taxes should be presented in a separate income tax section in the statement of cash flows. The Basis for Conclusions notes that allocating tax cash flows to separate sections would be complex and arbitrary. This reflects the prevalent practice that tax is generally assessed on a legal entity's total income or expenses rather than its individual activities. It is also frequently the case that the tax paid in a period is based on the transactions of an earlier period: in that circumstance the tax paid on operating activities relates to an earlier period, and not the other cash flows reported in the statement of cash flows.
- 2.38 Furthermore, the most insightful analysis of an entity's financial position and prospects is usually made by separately evaluating transactions on a pre-tax basis and the entity's tax prospects (which is why financial statements generally report these separately).
- 2.39 It is therefore suggested that cash flows relating to tax should be reported in a separate section of the cash flow statement. This is consistent with the Financial Reporting Lab's report 'Operating and investing cash flows', which noted that all investors asked wanted separate disclosure of cash flows relating to tax.

### 3 Cash equivalents and the management of liquid resources

#### **Main suggestions made in this section**

*The statement of cash flows should report inflows and outflows of cash, rather than cash and cash equivalents.*

*A separate section of the statement of cash flows should report cash flows relating to the management of liquid resources. Liquid resources should be limited to assets that are readily convertible into cash, but should otherwise not be restrictively defined.*

*Entities should be required to disclose their policy for the management of liquid resources, and the classes of instruments that are treated as such.*

*Net presentation of cash flows (other than those in respect of operating activities) should be permitted only for cash flows relating to financial instruments that are of the same class.*

- 3.1 This section discusses the following issues:
- (i) the definition of cash and cash equivalents (paragraphs 3.4–3.15);
  - (ii) reporting information on the management of liquid resources (paragraphs 3.16–3.22); and
  - (iii) reporting gross or net cash flows (paragraphs 3.23–3.31).
- 3.2 One might expect that if an entity makes a cash payment to buy an asset, that cash outflow would be reported in the cash flow statement. However, if the cash flow statement is prepared in accordance with IAS 7, there are two reasons why this might not be the case:
- the purchased asset is within the definition of ‘cash equivalents’; or
  - the cash outflow qualifies for netting with a cash inflow.
- 3.3 As is explained below, IAS 7 requires information on changes in ‘cash and cash equivalents’ rather than cash. This section argues that a better approach is to eliminate the notion of cash equivalents, and to require information on the management of liquid resources to be reported in a separate section of the cash flow statement. It also reviews the circumstances in which cash inflows and outflows should be set against each other with only the net amount reported.

#### **‘Cash and cash equivalents’**

- 3.4 IAS 7 defines ‘cash flows’ as inflows and outflows of cash and cash equivalents. In turn:
- (i) cash is defined as ‘*cash on hand and demand deposits*’; and
  - (ii) cash equivalents are defined as ‘*short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value*’.
- 3.5 IAS 7 then notes that:
- (i) bank overdrafts which are repayable on demand are included in cash and cash equivalents when they ‘*form an integral part of an entity’s cash management*’; and
  - (ii) an investment ‘*normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition*’.

3.6 IAS 7 explains that:

*Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.*

3.7 The focus on movements of cash and cash equivalents was reconsidered in the IASB's 2008 Discussion Paper 'Preliminary Views on Financial Statement Presentation' (at paragraphs 3.14–3.18). It concluded that the concept of 'cash equivalent' should not be retained: the statement of cash flows should show only movements in cash. The Discussion Paper noted that a consequence of this proposal is that cash flows relating to the purchase and sale of investments that would qualify as cash equivalents under IAS 7 would be reported in the cash flow statement. However, it stated that these cash flows would qualify for net presentation under the requirements of IAS 7, for which it proposed no change.

3.8 The definition of cash equivalents seeks to capture short-term investments that are essentially the same as cash. The justification may be that, because of this equivalence, exchanges of cash for such investments are largely irrelevant to users' information needs.

3.9 It is, however, inevitably arbitrary to define which investments are sufficiently close to cash to merit inclusion in 'cash equivalents'. There is no clear reason why a maturity of three months from acquisition is better than, say, two or four months. This aspect of the definition also leads to an odd distinction between assets depending on their maturity at the time of acquisition. For example, a purchase of a bond with four months remaining maturity would be reported as an investing cash flow: if the holding is increased six weeks later, no cash flow is reported.<sup>17</sup> A further issue is that subjectivity is inevitable in interpreting 'insignificant risk of changes in value' in considering whether the definition of cash equivalents is met. Thus, IAS 7's description of 'cash equivalents' achieves the doubtful distinction of being both arbitrary and subjective.

3.10 As noted in paragraph 3.6, one of the motivations for the introduction of 'cash and cash equivalents' was to reflect an entity's management of cash and other liquid resources. It is, however, unlikely that all entities manage cash and liquid resources using the same classes of instruments. A standard definition of cash equivalents cannot therefore reflect the way in which all entities are managed. In other words, it forces entities to report as if they managed their liquid resources in way that is prescribed by the standard-setter.

3.11 It may also be questioned whether any investments are in fact equivalent to cash. The Discussion Paper noted that cash—and not investments—are required to pay employees and suppliers, and to make distributions to investors. It went on to note:

*Although an entity would usually be able to convert cash equivalents to cash quickly to satisfy its need for cash, no short-term investment can have all the characteristics of currency on hand and on-demand deposits. For example, regardless of how near its maturity, a short-term investment is subject to some risk of price change attributable to, for example, sudden changes in the credit environment or the perceived credit quality of the issuer. (paragraph 3.17)*

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<sup>17</sup> The IFRS Interpretations Committee decided in May 2013 (<http://media.ifrs.org/2013/IFRIC/May/IFRICUpdateMay2013.pdf>) not to add to its agenda a proposal that cash equivalents should be based on the remaining maturity at the balance sheet date rather than that at the date of acquisition. (accessed 10 October 2016).

- 3.12 In summary, a focus on ‘cash and cash equivalents’:
- (i) relies on distinctions that are arbitrary and subjective (and hence may be expected to impair comparability between entities);
  - (ii) cannot faithfully reflect the liquidity management policies of all entities; and
  - (iii) ignores differences between cash and investments, which in some circumstances are significant.

- 3.13 Because of these shortcomings, it is recommended that the statement of cash flows should focus on cash, rather than ‘cash and cash equivalents’. The guiding principle is that cash should be instruments that can be used to pay expenses and meet financial obligations. The following might provide a starting point for a definition:

*Cash comprises cash on hand, and deposits with and advances from banks and similar financial institutions that are repayable on demand.*

The changes from the IAS 7 definition of cash are:

- (i) advances from banks and similar financial institutions that are repayable on demand (i.e. bank overdrafts) are explicitly included in the definition rather than accommodated in supporting explanation; and
  - (ii) it is explicit that only demand deposits with banks and similar financial institutions qualify as cash.
- 3.14 It is perhaps helpful to clarify that not all loans that are repayable on demand can qualify as cash. This would exclude, for example, a loan made without stated terms to a related party. The reference to ‘similar financial institutions’ would include, for example, deposits with co-operative savings institutions.
- 3.15 Of course, not all cash is available to meet all financial obligations. It may be in the wrong currency or in a geographical location from which it cannot be moved without adverse consequences, such as giving rise to a tax charge. As noted in the Introduction, the reporting of restricted cash is not an issue that is addressed in this paper.

### **Management of liquid resources**

- 3.16 The discussion above rejected the notion of cash and cash equivalents because it did not provide a meaningful insight into an entity’s management of liquid resources. Providing such an insight is, however, clearly useful: indeed, it is arguable that providing information that assists an assessment of liquidity is one of the main objectives of the cash flow statement.
- 3.17 It would therefore be valuable if the statement of cash flows contained a section that was devoted to the management of liquid resources. This would highlight the nature of such resources and changes in them. This could be achieved by introducing a new separate section of the statement of cash flows specifically for management of liquid resources.
- 3.18 Implementing such an approach would require consideration of which assets should be included as ‘liquid resources’. However, as noted above, liquidity management policies vary widely between entities, and no accounting standard will therefore reflect the way in which all entities are managed. Allowing some discretion in which assets are regarded as ‘liquid resources’ would allow cash flow information to be consistent with policies for liquidity management. It would also assist users in making a critical assessment of these policies: disclosure requirements to assist this are discussed below.
- 3.19 The main distinguishing feature of assets that can reasonably be regarded as ‘liquid resources’ is that they should be liquid—that is, readily convertible into cash. Where an

asset is traded on an active market (to which the entity has access), it would be readily convertible into cash.

- 3.20 The notion of 'readily convertible into cash' forms part of the definition of cash equivalents in IAS 7, as noted in paragraph 3.4. That definition also requires that cash equivalents be 'subject to insignificant risk of changes in value'. The basis for this seems to be that holding investments for the management of liquid resources is incompatible with accepting an exposure to the risk of price changes. Putting this another way, if an entity holds assets that expose it to price changes it should be regarded as engaging in investing activities rather than managing liquid resources.
- 3.21 It is, however, questionable whether such a restriction is necessary or appropriate. Management of liquid resources will inevitably require consideration of a number of objectives, including judgements as to what risks should be accepted at what price. A restriction on the risks that might be accepted on investment of liquid resources would be arbitrary.
- 3.22 Disclosures necessary for management of liquid resources include:
- (i) the entity's policy for the management of liquid resources; and
  - (ii) the assets that are regarded as liquid resources, and changes in them. It should be possible to reconcile changes in such assets with amounts shown in the statement of financial position. This could be achieved by reference to the classes of financial instruments identified in accordance with paragraph 6 of IFRS 7 'Financial Instruments: Disclosures'.

### **Gross or net cash flows?**

- 3.23 As noted in paragraph 3.7, the 2008 Discussion Paper proposed that the notion of 'cash equivalents' should not be retained. It reasoned that cash flows relating to the purchase and sale of investments that would qualify as cash equivalents under IAS 7 would qualify for net presentation under the requirements of IAS 7, for which it proposed no change.
- 3.24 FAS 95 'Statement of Cash Flows', which in many respects closely resembles IAS 7, states 'Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments' (paragraph 11). However, both FAS 95 and IAS 7 permit some cash flows to be reported net.
- 3.25 Where the indirect method is used to prepare the operating activities section of the cash flow statement, only net cash flows are presented. So the question of whether cash flows should be presented net or gross is mainly relevant for the investing and financing sections of the statement of cash flows.
- 3.26 The requirements of IAS 7 for presenting cash flows net include some provisions that are mainly relevant to financial institutions. Its requirement that is relevant for present purposes is that the following cash flows may be presented net:
- '...cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.'* (paragraph 22b)
- 3.27 This is a rather odd requirement. The reference to short maturities seems to restrict it to debt instruments, although this is not explicitly stated. The notions of 'quick turnover'; 'large amounts'; and 'short maturities' are rather vague. That said, it does not seem to have given rise to significant difficulty of interpretation or troublesome diversity in

practice. If that is correct, it suggests that the wisest course might be to make no change.

- 3.28 A further consideration is whether the requirements are on point. The underlying thought seems to be that cash flows relating to short-term investments and loans are not relevant. This is suggested by the Basis for Conclusions to FAS 95, which states, in part:

*For very short-term investments, loans, and debt, relatively insignificant differences in the maturities of items may result in large differences in gross cash flows between enterprises or between periods that are not particularly meaningful. For example, an enterprise that issues seven-day commercial paper and rolls it over every week would report financing cash inflows and outflows four times those of an enterprise that issues one-month paper. While all gross cash flows are potentially relevant, the large reported differences in situations such as that described may not be sufficiently meaningful to require reporting of gross cash flows. The Board therefore decided to permit cash flows stemming from all investments, loans, and debt with original maturities of three months or less to be reported net. (paragraph 79)*

- 3.29 It may be noted that the conclusion in the last sentence of the quotation is broader than that justified by the preceding example. The example is of rollover of a commercial paper programme where each rollover would typically be on the same terms, i.e. those established by the programme, but the conclusion embraces all short maturity investments and loans.
- 3.30 However, the example seems convincing that netting is appropriate for transactions that are the rollover or reissue of substantially the same investment. And once that is acknowledged it is difficult to know where to stop. For example, there seems little relevance in reporting gross cash flows where the proceeds received on maturity of an investment in commercial paper issued by a high quality corporate are invested in similar commercial paper issued by a different corporate. On the other hand, it would seem relevant to report the cash flows relating to the sale and purchase of investments of different classes. As with the disclosure of liquid resources, the degree of aggregation could correspond to classes of financial instruments identified in accordance with paragraph 6 of IFRS 7.
- 3.31 It is therefore concluded that net presentation of cash flows (other than those in respect of operating activities) should be permitted only for cash flows relating to financial instruments that are of the same class.

## 4 Reconciliation of operating activities

### **Main suggestions made in this section**

*A reconciliation of profit and cash flow should be presented in all cases (including where a direct method cash flow statement is presented). The reconciliation should be required to reconcile a sub-total in the statement of profit or loss that represents operating income (rather than, for example, net profit or loss) and reconcile that to cash flow from operating activities.*

*Because the amounts reported in the reconciliation are not cash flows, the reconciliation should not be reported within the statement of cash flows itself, but as a supplementary note, perhaps immediately following the statement of cash flows.*

### **Reconciliation and definition**

- 4.1 Under present practice, a reconciliation is generally given between cash flows from operating activities and the statement of profit or loss.<sup>18</sup> The reconciliation often starts with profit before taxation, and adjustments are made for:
- (i) items that do not represent cash flows (e.g. depreciation);
  - (ii) items that relate to the 'investing' and 'financing' sections rather than operating; and
  - (iii) changes in working capital.
- 4.2 This reconciliation is generally provided where the indirect method is used. The IASB staff draft of an exposure draft 'Financial Statement Presentation' of July 2010 proposed that the direct method be required, but that a reconciliation should also be provided. The 2008 Discussion Paper 'Preliminary Views on Financial Statement Presentation' proposed a schedule reconciling the cash flow statement and the statement of comprehensive income line-by-line.
- 4.3 The evident importance attached to the reconciliation is not surprising. Specifically:
- it explains the relationship between a measure of operating performance and cash generation, which assists in an assessment of the quality of earnings and hence an assessment of future earnings and cash flow; and
  - it provides information on changes in working capital, and so assists an assessment of the efficiency with which resources have been managed.
- 4.4 Under present practice, the reconciliation may start with any line item in the statement of profit or loss. For example, profit after tax may be used. It is understood that the US Securities and Exchange Commission has challenged the reporting by companies of cash flows starting from anything other than net profit or loss.<sup>19</sup> However, there is some evidence<sup>20</sup> that investors prefer the statement to start from a sub-total on the statement of profit or loss that represents 'operating' income. This has the advantage that it clearly aligns the cash flow from operations and operating income. Because fewer reconciling items are required, the reconciliation will be more transparent and easier to understand.

<sup>18</sup> IAS 7 also permits the direct method to be used. It also recognises an alternative method of preparing an indirect method cash flow statement, which adjusts revenue and expenses for the change in inventories and operating receivables and payables.

<sup>19</sup> FRC Financial Reporting Lab Project Report: Operating and Investing Cash Flows (November 2012).

<sup>20</sup> Financial Reporting Lab *op cit*.

A requirement specifically to reconcile profit or loss from operating activities and net cash flows from operating activities was proposed in the IASB's staff draft of an exposure draft 'Financial Statement Presentation' of July 2010.

- 4.5 It may be difficult to implement such a requirement because there is at present no requirement to disclose 'profit or loss from operating activities'. Such a requirement was included in the 1997 version of IAS 1 'Presentation of Financial Statements', but it has now been deleted. The Basis for Conclusions to the current version records that the Board did not wish to require disclosure of an undefined term. It also (perhaps curiously) provides guidance to those who elect to make such disclosure (paragraphs BC55–BC56).
- 4.6 It is obviously difficult to define 'operating activities' with sufficient precision to ensure that it will be applied completely consistently in practice. However, it would seem to be possible to give sufficient guidance to ensure that it is meaningful. It would also be possible to prescribe additional disclosures to ensure that the user was aware of the definition used. Whilst inconsistent application detracts from comparability, some flexibility in the definition may increase the relevance of what is reported, as management would have some freedom to determine what is regarded as 'operating activities'. Investors have told us that management's view on an entity's operating activities is in itself useful information. Paragraph 2.4 suggests a possible approach towards definition or description of operating activities.

### **Location of the reconciliation**

- 4.7 Under present practice, the reconciliation is usually presented as the first section of the statement of cash flows. That is, the first line of the cash flow statement is a measure of income (and not cash) that is then adjusted for the items set out in paragraph 4.1. These are also not cash flows. Fundamentally, the reconciliation does not provide information on cash flows: rather it explains how information on cash flows relates to information prepared on an accruals basis.
- 4.8 The FRC's Financial Reporting Lab asked investors (more than 30 individuals from 16 investment organisations) whether they preferred the reconciliation to be shown at the top of the financial statements or in a note.<sup>21</sup> Most preferred it to be presented as part of the cash flow statement. They argued that this was consistent with the importance of the reconciliation, and is easier and less time-consuming to use. They also said it was particularly helpful when viewing reports on electronic media.
- 4.9 Two dissenting FASB members (Raymond C Lauer and Robert J Swieringa) considered that presenting a reconciliation of net income and net cash flow from operating activities within the statement of cash flows rather than in a separate schedule was 'confusing and counter to the primary purpose of a statement of cash flows'.
- 4.10 It is indeed questionable if less sophisticated users find it intuitive or understandable if a cash flow statement starts with an item that is not a cash flow and then adds and subtracts items that are also not cash flows. Such a user might conclude, for example, that the reason that cash from operating activities is greater than last year is because depreciation has increased!
- 4.11 Whilst recognising the views expressed by investors, it is difficult to believe that sophisticated users would suffer a major detriment if the reconciliation appeared in a prominent supplementary note to the cash flow statement. Indeed, the FRC's recent investor outreach suggested that the location of the reconciliation was relatively unimportant.

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<sup>21</sup> FRC Financial Reporting Lab Project Report: *op cit*.

- 4.12 The *Conceptual Framework* states that ‘Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently’ (paragraph QC32). The issue therefore is whether to assume that users will be able to locate a reconciliation presented as supplementary to the cash flow statement, or to assume that users who review a cash flows statement that includes a reconciliation will readily understand which items are cash flows and which are not.
- 4.13 The reconciliation does not report cash flows, and does not relate to the primary purpose of the statement of cash flow. Thus including it in the statement of cash may cause confusion. It would be preferable for it to be required to be reported in a supplementary note, rather than within the statement itself.

## 5 Direct or indirect method?

### **Main suggestions made in this section**

*It is not necessary for an accounting standard to require or permit a specific method for deriving 'cash flow from operations'. As a reconciliation of profit and cash flow from operating activities is to be required, the indirect method is likely to be widely used in practice: however, the direct method should not be prohibited.*

*However, an accounting standard should identify components of cash flow from operating activities that are particularly significant, and require disclosure either of the amount of such components or of changes in related working capital items.*

- 5.1 Perhaps the issue that has attracted most controversy about the cash flow statement is whether the direct or indirect method should be used. Under the direct method the actual amount of a cash flow relating to classes of transactions within operating activities is disclosed—for example, the amount of cash collected from customers. Under the indirect method, the cash flow statement adjusts an amount of profit for non-cash items in order to derive the amount of cash flow from operating activities. Financing and investing activities are reported under the direct method.
- 5.2 IAS 7 encourages cash flow relating to operating activities to be reported using the direct method, but permits the indirect method as an alternative.
- 5.3 Those who advocate the use of the direct method note that:
- (i) The direct method reports the actual cash flows relating to each activity and line item that is reported.
  - (ii) A direct method is more intuitive and easier to understand.
  - (iii) Where a direct method is used, the cash flows relating to operating activities can be disaggregated. Thus, for example, cash received from customers; cash paid to suppliers; and cash paid to employees may be separately reported. This disaggregation can assist users in assessing the amount, timing and uncertainty of future cash flows.
- 5.4 Hales and Orpurt<sup>22</sup> review the academic literature and report that it confirms that the components of cash flow obtained by the direct method provide information useful for predicting future operating cash flow and earnings. Gebhardt and Scholz<sup>23</sup>, however, question whether the currently available academic research is sufficient to support the conclusion that the direct method should be required where an indirect method reconciliation is also presented.
- 5.5 A requirement to use the direct method was proposed in the IASB's Discussion Paper 'Preliminary Views on Financial Statement Presentation' (October 2008) and the staff draft of an exposure draft 'Financial Statement Presentation' of July 2010. Responses and outreach in connection with these revealed that many disagreed. One of the main concerns expressed was the cost that such a change would impose on preparers of

<sup>22</sup> Jeffrey Hales and Steven F Orpurt (2013) *A Review of Academic Research on the Reporting of Cash Flows from Operations* Accounting Horizons, Vol. 27 No.3 pp. 539–578.

<sup>23</sup> Günther Gebhardt and Michael Scholz (2014) *The Costs and Benefits of Requiring an Additional Presentation of Direct Cash Flow Statements: Evidence from Accounting Practice and Empirical Research*. (Available at <http://ssrn.com/abstract=2747921>).

financial statements. It may be, however, that much of the cost would be in making the changes to systems necessary to produce a direct method cash flow statement, and that on-going cost implications would not be great. This would be consistent with some evidence from Australia that entities that previously were required to use the direct method and, following the move to IFRS are now permitted a choice, continue to use the direct method.

- 5.6 Rather than preparing a direct method statement of cash flows from cash records (the 'direct direct method') a direct method cash flow statement can be prepared by adjusting a statement of profit or loss line item for changes in related assets and liabilities (the 'indirect direct method'). For example, the amount of cash collected from customers can, in a simple case, be found by adjusting turnover by the amount of changes in customer receivables. Preparers are, however, not persuaded that expressly permitting the indirect direct method would significantly reduce costs. There is also some unease about reporting amounts that may be thought to be highly significant and objective if it is the product of a process that requires the use of estimates.
- 5.7 It is sometimes suggested that investors and other users of financial statements prefer a direct method cash flow statement. However, the evidence is rather equivocal. Outreach carried out by the FRC shows that views are divided: although a significant number (perhaps a small majority) prefer a direct method statement of cash flows, many express a preference for the indirect method. A recent study from the Confederation of Swedish Enterprise<sup>24</sup>, which is based on forty in-depth interviews with experienced capital market participants, concluded:
- Most interviewees told us that they looked at the actual statement of cash flows, focusing e.g. on changes in working capital. Another common focus area in the cash flow statement was depreciations/amortizations. These findings indicate that experienced users find information that is available in an indirect cash flow statement to be useful. No interviewee indicated that they would have preferred a direct statement of cash flow.*
- 5.8 Section 4 of this paper proposes that a reconciliation should be provided between profit and cash flow from operating activities. That reconciliation provides much of the important information that is provided by an indirect method statement of cash flows as presented under current practice. This seems to change the question: rather than being whether the direct or indirect method should be required or permitted, the issue becomes: what more detailed information on the components of cash flow from operating activities should be required?
- 5.9 For example, cash collected from customers is often mentioned as a particularly important item for financial analysis. It would be possible to require disclosure of that amount. If so, it could be emphasised that it could be prepared by the indirect direct method. It is possible that the unease referred to in paragraph 5.6 about reporting amounts derived by that method above would be less severe if it were a supplementary disclosure.
- 5.10 An alternative approach would be to require additional disclosures that would assist users to derive the amount of components of cash flows from operating activities. For example, if the change in accounts receivable from customers were separately reported it would be possible for users to derive the amount of cash received from customers. But this is true only if the changes in accounts receivable from customers are:
- (i) increases due to sales; and
  - (ii) decreases due to cash collections.

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<sup>24</sup> Dr Anja Hjelström, Dr Tomas Hjelström and Dr Ebba Sjögren *Decision Usefulness Explored: An investigation of capital market actors' use of financial reports*. Svenskt Näringsliv (Confederation of Swedish Enterprise), April 2014.

But there may be other changes—for example from the effect of changes in foreign currency rates and impairments. So this disclosure achieves its objectives only imperfectly. Indeed, some investors are frustrated that the change in amounts reported in the statement of financial position cannot be reconciled to amounts reported in the statement(s) of financial performance and the statement of cash flows. They would urge a full reconciliation of each line item.

- 5.11 Clearly, standard-setters need evidence to judge the appropriate balance between cost and benefits. The issues are:
- (i) Which line items are particularly important and therefore accounting standards should require the disclosure of information relevant to that item?
  - (ii) Should the requirement be to disclose the aggregate cash flows relating to the line item, or to disclose separately the corresponding working capital amounts? Should a detailed reconciliation of the working capital amounts be required?
- 5.12 It will also be necessary to consider whether any or all of the required components should be within the statement of cash flows or presented as supplementary information. It is, however, clear that the usefulness of the information required can be improved beyond that required by IAS 7, which can be interpreted as not requiring any of the components of changes in working capital to be disclosed.
- 5.13 There is, of course, nothing to prevent the disclosure of information beyond the minimum requirements of a standard. Thus entities that elect to include a detailed cash flow statement prepared under the direct method in their financial statements would be free to do so, provided the prescribed components were disclosed.

\* \* \* \* \*

## Appendix A Overview of the suggestions made in this paper

The following table summarises the main suggestions made in this paper and compares them with what is currently required by IAS 7 'Statement of Cash Flows'. The suggestions are best understood within the context of the discussion provided in the body of the paper.

<b>The usefulness of information about cash flows (Section 1)</b>	
<i>Requirements of current IAS 7</i>	<i>Suggestions made in this paper</i>
Investing and financing activities that do not require the use of cash shall be excluded from a statement of cash flows, but such transactions shall be disclosed elsewhere in the financial statements. (paragraphs 43 and 44)	Notional cash flows should not be reported in any section of the statement of cash flows. However, transparent disclosure of non-cash transactions should be required.
<b>The classification of cash flows (Section 2)</b>	
<i>Requirements of current IAS 7</i>	<i>Suggestions made in this paper</i>
'Operating activities' include all activities that do not meet the definition of investing or financing activities. (paragraph 6)	<p>Operating activities should be positively defined or described (perhaps as including transactions with customers, employees and suppliers) rather than being a residual or default classification.</p> <p>It should be clear that items should not be excluded from operating activities merely because they are unusual or non-recurring. However, these items should be separately disclosed.</p> <p>Items that do not relate to operating activities (or another defined section of the cash flow statement) should be reported in a separate section of the cash flow statement.</p>
<p>Cash payments to acquire property, plant and equipment, intangibles and other long-term assets are reported within cash flows from investing activities. (paragraph 16(a))</p> <p>Entities are encouraged to disclose the aggregate cash flows that represent increases in operating capacity separately from those that are required to maintain operating capacity. (paragraph 50(c))</p>	<p>Cash outflows to acquire property, plant and equipment should be reported as a cash outflow from operating activities. As such outflows are likely to be volatile, a sub-total of cash generated from operating activities before capital expenditure should be disclosed.</p> <p>Entities should be encouraged to disclose the extent to which expenditure on property, plant and equipment represents 'replacement' or 'expansion'.</p>

<b>The classification of cash flows (Section 2) (continued)</b>	
<i>Requirements of current IAS 7</i>	<i>Suggestions made in this paper</i>
Cash flows from interest and dividends received and paid shall be classified consistently as either operating, investing or financing activities. (paragraph 31)	Cash flows on financing liabilities (including the payment of interest) should be reported in the financing category of the cash flow statement. Cash received from customers (including any amount treated as interest income in the statement of profit or loss) should be reported within cash flow from operating activities.
Cash flows arising from taxes on income shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. (paragraph 35)	Cash flows relating to tax should be reported in a separate section of the statement of cash flows.
<b>Cash equivalents and the management of liquid resources (Section 3)</b>	
<i>Requirements of current IAS 7</i>	<i>Suggestions made in this paper</i>
Cash flows are defined as inflows and outflows of cash and cash equivalents. (paragraph 6)	The statement of cash flows should report inflows and outflows of cash, rather than cash and cash equivalents. A separate section of the statement of cash flows should report cash flows relating to the management of liquid resources. Liquid resources should be limited to assets that are readily convertible into cash, but should otherwise not be restrictively defined. Entities should be required to disclose their policy for the management of liquid resources, and the classes of instruments that are treated as such.
<b>Reconciliation of operating activities (Section 4)</b>	
<i>Requirements of current IAS 7</i>	<i>Suggestions made in this paper</i>
<p>No reconciliation is required where a direct method cash flow statement is presented. (paragraphs 18–20)</p> <p>It is implied that a reconciliation is required where an indirect method cash flow statement is presented.</p>	<p>A reconciliation of profit and cash flow should be presented in all cases (including where a direct method cash flow statement is presented). The reconciliation should be required to reconcile a sub-total in the statement of profit or loss that represents operating income (rather than, for example, net profit or loss) and reconcile that to cash flow from operating activities.</p> <p>Because the amounts reported in the reconciliation are not cash flows, the reconciliation should not be reported within the statement of cash flows itself, but as a supplementary note, perhaps immediately following the statement of cash flows.</p>

<b>Direct or indirect method (Section 5)</b>	
<i>Requirements of current IAS 7</i>	<i>Suggestions made in this paper</i>
<p>Use of the direct method for presenting cash flow from operating activities is encouraged but not required. (paragraphs 18–19)</p> <p>An indirect method of deriving net cash flow from operating activities may be derived either:</p> <ul style="list-style-type: none"> <li>(i) by adjusting profit or loss for: changes in inventories and operating receivables and payables; non-cash items; and items for which the cash effects are investing financing cash flows; or</li> <li>(ii) by adjusting the revenue and expenses disclosed in the statement of comprehensive income for changes in inventories and operating receivables and payables. (paragraph 20)</li> </ul>	<p>It is not necessary for an accounting standard to require or permit a specific method for deriving 'cash flow from operations'. As a reconciliation of profit and cash flow from operating activities is to be required, the indirect method is likely to be widely used in practice: however the direct method should not be prohibited.</p> <p>However, an accounting standard should identify components of cash flow from operating activities that are particularly significant, and require disclosure either of the amount of such components or of changes in related working capital items.</p>

## Appendix B: Illustration of the suggestions made in this paper

The following sets out one of the illustrative examples set out in IAS 7 and then shows how that example might be recast in accordance with the suggestions made in this paper.

### IAS 7 Illustrative Example A: Statement of cash flows for an entity other than a financial institution (indirect method)

#### Cash flow from operating activities

Profit before taxation	3,350	
Adjustments for:		
Depreciation	450	
Foreign exchange loss	40	
Investment income	(500)	
Interest expense	400	
	3,740	
Increase in trade and other receivables	(500)	
Decrease in inventories	1,050	
Decrease in trade payables	(1,740)	
	2,550	
Cash generated from operations	2,550	
Interest paid	(270)	
Income taxes paid	(900)	
	1,380	1,380
<i>Net cash from operating activities</i>		

#### Cash flows from investing activities

Acquisition of subsidiary X net of cash acquired	(550)	
Purchase of property, plant and equipment	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	200	
	(480)	(480)
<i>Net cash used in investing activities</i>		

#### Cash flows from financing activities

Proceeds from the sale of share capital	250	
Proceeds from long-term borrowing	250	
Payment of lease liabilities	(90)	
Dividends paid	(1,200)	
	(790)	(790)
<i>Net cash used in financing activities</i>		

<b>Net increase in cash and cash equivalents</b>	110
<b>Cash and cash equivalents at beginning of period</b>	120
<b>Cash and cash equivalents at end of period</b>	230

The same example, recast to illustrate the draft Discussion Paper's suggestions

*Statement of cash flows*

**Cash flow from operating activities**

Cash generated from operations, before capital expenditure	3,050	
Purchase of property, plant and equipment	(350)	
Proceeds from sale of equipment	20	
<i>Net cash from operating activities</i>		2,720

**Cash outflow relating to takeover defence** (500)

**Cash flows from investing activities**

Acquisition of subsidiary X net of cash acquired	(550)	
Interest received	200	
Dividends received	200	
<i>Net cash used in investing activities</i>		(150)

**Cash flows from financing activities**

Proceeds from the sale of share capital	250	
Proceeds from long-term borrowing	250	
Payments to providers of debt finance	(270)	
Payment of lease liabilities	(90)	
Dividends paid	(1,200)	
<i>Net cash used in financing activities</i>		(1,060)

**Income taxes paid** (900)

**Net increase in liquid resources** 110

**Management of liquid resources**

Purchase of short-term investments	(180)	
Sale of short-term investments	85	
<i>Net cash invested in liquid resources</i>		(95)

**Increase in cash** 15

**Cash at beginning of period** 25

**Cash at end of period** 40

**Reconciliation of  
profit and cash flow from operating activities**

Profit from operating activities		3,790
Non cash income and expenses:		
Depreciation	450	
		450
Changes in working capital:		
Increase in trade and other receivables	(500)	
Decrease in inventories	1,050	
Decrease in trade payables	(1,740)	
		(1,190)
Cash generated from operations, before capital expenditure		3,050

Note: The assumptions on which this example is based are the same as those set out in IAS 7 for Illustrative Example A, except that it has been additionally assumed that:

- (i) There has been a cash outflow of CU 500 relating to the defence of a takeover, which was included in cash flow from operating activities under the requirements of IAS 7. The same amount was included in administrative and selling expenses in the statement of comprehensive income.
- (ii) The cash flows relating to purchases and sales of short-term investments were respectively CU 180 and CU 85.

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Andrew Lennard  
Financial Reporting Council  
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EC2Y 5AS

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