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Our ref dl/tn

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Dear Mr Lennard

Discussion paper – Improving the statement of cash flows

We welcome the opportunity to comment on the FRC's *Discussion paper – Improving the statement of cash flows*.

We support the FRC's discussion paper as a positive contribution to a wider reconsideration of corporate reporting generally, and financial statements in particular. Our overarching comment is that it is imperative that the needs of users are better understood if any change to the information presented is to improve the relevance of financial statements.

However, we are not convinced that there is yet sufficient clarity about those needs to propose particular changes and are concerned that the discussion paper alone may not create such clarity, particularly as we suspect that there is diversity of need. We therefore encourage a concerted outreach to a representative sample of individual investors for an open discussion of cash flow statements, including what they currently do (and do not) achieve, using some of the difficult issues in the discussion paper (factoring, cash equivalents etc) as a basis for discussion. Our hope is that a deeper understanding of the pros and cons of the existing cash flow statement and a better understanding of needs will emerge.

Once those needs are better understood, a consensus can more easily be built as to the appropriate response, whether that be changes to the existing cash flow statement; changes to the disclosures of cash and non-cash items in the notes to the financial statements (eg additional disaggregations and reconciliations); or whether an alternative statement, reporting something other than cash flows, would better meet those needs. In parallel with this, the objective must be more relevant financial information at a cost-effective price.

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Our responses to the questions set out in the discussion paper are included in the attached appendix.

Please contact David Littleford on 020 7694 8083 should you wish to discuss any of the comments further.

Yours faithfully

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Appendix

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

We agree with the principle that the statement of cash flows should aid the user's understanding of the company's liquidity (in the wide sense described in paragraph 1.3(i)).

Performance measure
With regard to a measure of performance, for example free cash flow, we recommend that the FRC explores with investors whether there is a consensus on the use of the cash flow statement and hence what is a useful measure: is a cash flow statement total or sub-total being used to derive a measure of performance or is it being used to supplement a performance measure that is 'accrual' based, for example EBITDA; in the latter case, how else is the supplementary cash flow information being used, for example to inform the quality of accrual-based earnings.

The absence of common understanding on how the combined income statement and cash flow information is being used may be contributing to diversity both in the information presented by preparers and its use by investors. The diversity, and confusion between cash flow and profit performance (eg adjusted EBITDA), is arguably contributing to the current concerns regarding non-GAAP measures.

Working capital management
We understand that working capital management is an important consideration for investors. However, currently it is difficult to determine what working capital includes and therefore the relevance of the increases or decreases reported in the cash flow reconciliation represent. The movements in receivables, payables etc in the statement of cash flows can rarely be reconciled with the relevant items in the balance sheet due to a lack of granularity and absence of a definition of "working capital" (either general or entity-specific). This is not surprising as these movements are not the object of the current cash flow statement but only a by-product of the indirect method. Shifting the focus to working capital raises the question of what elements of balance sheet management would be useful and practical in a primary statement. Any resolution might require significant additional disclosure in the financial statements and result in additional costs for preparers, and, therefore, we note that a cost-benefit analysis would be useful.

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?

We believe this area is complex, as illustrated in the debt factoring and leasing examples in the discussion paper. When IAS 7 was written there were fewer non-cash financing arrangements available. This leads to two distinct questions: (i) where certain 'difficult' cash flows should be classified and (ii) whether the cash flow statement, or, rather, a possible replacement, should reflect something beyond cash, or whether investors' needs can be met through additional disclosure in the notes.

As respects (i), the dilemma is the nature of the cash flow versus coherence with other primary statements. Prioritising coherence, the entries for debt factoring might result in a company showing no operating cash inflows, as the receipts from the factoring company would instead be classified as financing. Perhaps it is appropriate that a company that factors all of its receivables has operating cash outflows, but no inflows; or that a company that uses a reverse factoring arrangement has no operating outflows, only operating inflows from debtors; or perhaps not. We consider that investors should be asked how the cash flow effect of such transactions should most usefully be presented.

Finance leases (in effect commonplace after IFRS 16) illustrate (ii). In a cash flow statement there would be no entries at the time of the purchase, unlike if the asset were bought outright. Again, some might view this as unhelpful, in particular given the proposed additional disclosure in relation to operating versus expansionary capex.

The debt factoring problem could be resolved by requiring cash flows to be categorised according to the nature of the underlying transaction, though informational content is then lost regarding the effect of the change in timing of the flows. However, the same approach would not work for finance leases as there are no cash flows. If this were addressed by including notional cash flows, i.e. include a cash outflow for the "payment" for the asset and a cash inflow for the financing arrangement, the statement is something other than a cash flow statement – a statement of source and application of funds? Alternatively, a suitable net debt reconciliation, alongside a primary statement on the current cash basis, may be another way to address this. It is bound up with the question of what is desirable and practical in a primary statement about balance sheet management over time (how sets of assets/liabilities – cash, working capital, net debt – interacted over the year).

We consider that these are important issues relating to the relevance of corporate reporting and believe that they warrant direct outreach to investors to discuss and identify an appropriate solution.

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

The default classification as operating, i.e. unless the cash flow meets the definition of investing or financing, is an effective anti-abuse measure. This has parallels with the ongoing debate over the exclusion of items of expense from operating profit and

adjusted measures of profit. Therefore, the benefit of operating being the default classification remains.

This conundrum also highlights whether a focus on one number (cash flows from operating activities) is appropriate. However, by including items by default in cash from operating activities it is clear where such items are and we believe a company will make clear any material items that they want investors to give specific consideration to in their analysis.

We support further consideration of a consistent approach to the classification of amounts as operating within the income statement and cash flow statement as suggested in paragraph 2.5. It is unclear whether such information would be useful to investors. The practicality of consistent classifications for all items of income, expense and cash flow, is also unclear. However, note that we have previously expressed concerns at IASB proposals for coherence across all primary statements on the basis of the classification adopted in the balance sheet (response dated 14 April 2009 to the IASB and FASB discussion paper *Preliminary views on financial statement presentation*).

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'?

If investors value additional information regarding the split of capital expenditure ("capex") between expansion and replacement, then we would support consideration of additional disclosure that might meet those needs. However, we note that there may be significant practical difficulties in estimating such a split. For example, often replacement assets will have an improved capacity or efficiency over the asset being replaced – would this type of asset be included wholly within replacement capex or split between expansion (representing the increased capacity/efficiency) and replacement capex? If the expenditure is to be split, how would this be done? For example, could depreciated replacement cost be used to determine the replacement element of the capex?

Similar considerations may apply to certain types of expenditure that is not capitalised, for example research and development expenditure (that does not meet the criteria for capitalisation in IAS 38) or exploration and evaluation expenditure where the accounting policy is to expense. An understanding of how investors use such information may help inform any proposals.

In terms of the appropriate presentation, we are unconvinced that all capex should be included in operating activities, with a subtotal as proposed. Why would such classification provide more relevant and reliable information than classification as investing with additional disclosure? This again suggests that the subtotal has some

special meaning above the informational content of the statement / disclosures taken together as a whole (again, there are parallels to non-GAAP measures here).

In the absence of compelling arguments that the proposed subtotal has informational value above its separately disclosed components, we would not support creating an expectation of its relevance.

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

Calculation of interest used to be relatively simple, but the introduction of more complex financing arrangements has caused accounting for interest to become more complicated (for example, the income statement now includes an effective interest rate that may bear little resemblance to the periodic cash flows). In terms of cash flows, it can be difficult to identify the amounts allocated to interest from repayments of capital, as illustrated by the zero coupon bond example. We therefore support reconsideration of whether it would be more appropriate to include the total cash flow (including interest) in financing cash flows.

The nature of a dividend *received* is a return on capital invested and therefore we agree that this should be classified as investing. A dividend *paid* is a return to shareholders and therefore we agree that this is a financing activity.

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

The consultation is not explicit as to whether the question is referring to income taxes or also to indirect taxes (such as VAT). The nature of each is different and therefore it could be argued that they warrant separate consideration, e.g. if the direct method is used to arrive at operating cash flows then it could be argued that it is more appropriate to recognise the indirect tax with the related receipts from customers/payments to suppliers than to show this separately, whereas it might be more appropriate for income taxes, which are harder to classify as operating, financing or investing, to be shown separately. However, it should be noted that different tax jurisdictions will have a different balance between their use of income taxes and indirect taxes. As such it could be argued that all tax should be considered together and treated in the same way to ensure a higher level of consistency across companies. We encourage further consultation on how best to present taxes, and different types of taxes.

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?

If a cash flow statement remains relevant, then we believe that the statement of cash flows should report flows of cash; cash equivalents should be presented separately, in

a similar manner to other short-term investments. We believe that providing information about an entity's short-term liquid assets is important. However, the definition of cash equivalents is currently open to different interpretations and we are unconvinced of the informational value of a different treatment of cash equivalents from other short-term assets.

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

Netting of inflows and outflows can assist users in some circumstances, but in others can represent a loss of information about the gross flows. It would be helpful to explore with investors when netting is appropriate to consider whether the criteria in IAS 7 could be enhanced.

Question 9 – In your view, is it appropriate to require the presentation of a reconciliation of operating activities in all cases, and to prohibit presenting it within the statement of cash flows?

We agree that a schedule reconciling a measure of profit to cash flows is relevant to users' understanding of the amount, timing and uncertainty of an entity's future cash flows, because it would link the cash, accrual and measurement components between the income statement and cash flows, particularly if the direct method is used for the statement of cash flows. We comment above on questions of reconciling items related to working capital.

We believe that the most appropriate profit number to start from would be operating profit as this removes the need to reconcile from net profit, or profit before tax, to operating profit as many do currently. However, it must be clear how operating profit has been defined and the cash flows associated with any "exceptional" or other items excluded should be made clear.

We do not propose prohibiting, or requiring, the reconciliation from being presented with the statement of cash flows as long as it clear in the statement where the reconciliation can be found. If it is included in the statement it should be made clear that it includes non-cash items. (Presenting it on the same page as the cash flow statement, but carefully separated, is another simple solution.) However, we understand that investors are keen to have the reconciliation presented with the statement of cash flows for ease of use.

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

We believe it is important that the statement of cash flows provides information that is useful for its users, and the direct method can provide additional useful information. As such we agree that it 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?

We believe information should be included to the extent that it is useful to users of the accounts. However, as with all disclosures, this should only be to the extent that information is material, and where this causes significant additional cost it is important to weigh this against the benefit achieved. For example, inclusion of a reconciliation of working capital, as included in the statement of cash flows, to the amounts in the opening and closing balance sheet would provide useful information to investors, but would require significant additional disclosure by preparers.