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Dear Mr Lennard

Discussion Paper: Improving the Statement of Cash Flows

The Corporate Reporting Users' Forum welcomes the opportunity to comment on the discussion paper *Improving the Statement of Cash Flows*. We would like to draw your attention to two comment letters we wrote to the IASB and the FASB that are relevant to this topic from June 2008 and May 2009 which are both available at the [cruf.com](http://www.cruf.com) website.

http://www.cruf.com/joint_boards_letter_PE_june5th.pdf
http://cruf.com/fsp_comment_letter_may09.pdf

In particular the following sentence from the June 2008 letter, which highlights the frustration that we have with current reporting:

"We regard the fact that it is frequently impossible to reconcile the information shown in the cash flow statement with changes in the balance sheet and, more specifically, the fact that many companies do not report how cash flows reconcile to changes in their net debt position, as major flaws in current reporting."

We would also like to emphasise the importance of collaboration with the IASB and hope that this discussion paper will be incorporated into their project on Primary Financial Statements.

Our specific response to this discussion paper is set out below.

Question 1

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

CRUF participants tend to agree with the discussion as presented in the discussion paper and in particular believe that the accruals based representation of performance is the most meaningful. The one element in the discussion which was somewhat lacking was how the difference between the accruals based measure of profit and operating cash flow is used by investors for their analysis. The document tends to have focused on any indication of an issue with short-term "quality" of performance and also non-cash expenses like share-based compensation. In the view of CRUF participants there is a structural element to the difference which is equally important, being the cash absorbed by growing companies for capex greater than depreciation and a normal working capital cycle, with such differences implicit in any DCF with a terminal growth rate such that operating profit will not normally be a proxy for sustainable free cash flow in the terminal year (briefly referenced in 1.16). We note the reference made later in the document which highlights the need to disaggregate capex between maintenance and growth. If it were possible, then this would be warmly welcomed and we have heard many investors ask for this over the years, usually people who have never worked in industry. We think in practice the dividing line between maintenance and growth is so subjective that the question may not be worth asking. Most investments are a mixture of both as new equipment is usually more productive than the older equipment it is replacing (also see our response to question 4 below).

In addition, for most companies the use of the cash flow statement to highlight liquidity is of only marginal value as most analysts tend to focus on “net debt” and the maturity profile of financial liabilities.

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?

Given the current construct of the primary financial statements, CRUF participants on the whole think that improved transparency of “notional cash flows” should be required but concur that they need not be reported in the statement of cash flows. They should be shown as reconciling items in a reconciliation of “net debt” or “financing activities”. Most commonly, liabilities or assets that are generated by a notional flow will typically be considered as part of the definition of net debt including factoring and leasing balances.

A number of CRUF participants, however, would like to see the make-up of the primary financial statements addressed more holistically to meet their needs and believe that, rather than a statement of cash flows, the third statement should be a statement of net debt flows with a cash reconciliation at the bottom of that statement. The logic for this is that these CRUF participants see no economic difference between capital expenditure that is paid for by committing to a lease payment or through cash settlement and would like the gross cash flows to pass through a statement of net debt and reconcile with the capital expenditure in the fixed asset notes. This logic could be applied to many other transactions which include such notional flows but which better explain the timing differences between recognition in the profit and loss account and value transfer bridging the annual balance sheets. As an example, during the financial crisis when “cash” at banks was not readily accessible there were many instances where transactions were settled using other financial assets such as government bonds and in some cases gold, either of which are likely to form part of net debt for an entity. It would have made no sense for such non-cash settled purchases of assets or settlements of expenses to have never passed through “Cash Flow from Operations”. These participants also believe that crucial to this argument is the view that “the going concern principle” is a fundamental basis for accounting and that, where businesses are genuinely a going concern, net debt is more relevant than cash.

CRUF recognises that this opens a much wider debate but encourages the FRC and the IASB to work together to explore this.

Question 3

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

Yes. We have long argued that users tend to use “Enterprise Value” as a key measure of valuation and total capitalisation which is a measure of the value of the operations independent of capital structure. It can be argued therefore that a clear definition of what assets and liabilities are necessary for the operations and which cash flows relate to these items is critical and many of us agree that “operating” should not be the default category. Many users want to be able to identify the core operating activities of the business and the performance relating to that. The current financial statements do little to facilitate this analysis. For example, some CRUF participants want to distinguish temporary or exceptional cash flows (e.g. cash outflow relating to takeover defence) as being separate from operating cash flows as these could be significant for investment decision making.

In our experience, the cash flow statement is frequently difficult to reconcile to the other two statements, and often aggregates items in a way which is unhelpful to users. Moreover, understanding how events have been reflected in the three statements and how those statements link up is often difficult, sometimes impossible. It is for this reason we were broadly supportive of a “cohesiveness” approach at the time the IASB were looking at the Financial Statement Presentation Project (FSP).

To reiterate the point made earlier, comparability between similar companies and between transactions with similar underlying economics is an essential characteristic that users require from financial statements.

However, we are concerned that the balance sheet approach underlying the application of both the cohesiveness and the disaggregation concepts will not result in useful information for users if it is rigidly followed through the other two statements. For example, defined benefit pension promises are an operating cost at creation which are settled by establishing a financial liability instead of through a cash payment, indicating that cohesiveness would be challenged if there is a presumption that cohesiveness is totally rigid unless always cash-settled at the point of recognition.

What we need is to be able to trace the impact of a particular transaction (or class of transactions) across the three statements, and to see how they link together in that respect.

This is best done in separate note disclosures covering each of the key balance sheet lines, reconciling the opening and closing positions by identifying how the changes have been reflected in individual lines on the other two statements. It would also be helpful to see this information summarised in a statement reconciling the opening and closing balance sheets.

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'?

Some CRUF participants agree that they should be reported within operating activities. As mentioned previously, CRUF recognises the subjectivity involved in determining what element of capex is replacement / maintenance or expansion / growth but clearly analysts try to assess this independently and believe that management have better information to provide this split. In their opinion, all of this expenditure should appear as an operating cash flow rather than the growth component being allocated to a different part of the cash flow statement and it is likely that the split between replacement or expansion may well be confined to the narrative report given the difficulty in defining it objectively. In our view companies should also be encouraged to report separately investment in tangible assets and intangible assets, as these have very different characteristics. Companies should be discouraged from aggregating, for example, 'expenditure on tangible assets, intangible assets and other investments' which reduces the ability of investors to understand the underlying trends.

We might also argue that a similar analysis of working capital would be beneficial to understand variances from a typical working capital cycle that is expected to reverse over time, although we recognise this may be even more subjective than the capex analysis and as a result likely to be outside the scope of GAAP defined accounts.

However, some other CRUF participants believe that cash flows relating to property, plant and equipment (PP&E) should continue to be reported as investing activities. This is because they find the current categorisation of operating activities, investing activities, and financing activities as more understandable and more reflective of the way companies operate. Setting up a business involves three different aspects: 1) INVESTING into production assets, 2) FINANCING these assets (as well as any working capital needs) before you can 3) OPERATE and hopefully start "raking in the cash". Mixing aspects of investing, even if it just relates to "routine" replacements of existing production assets, is therefore not helpful from a conceptual perspective. It would also greatly exacerbate the volatility of operating cash flow and make it harder to interpret. At the moment, operating cash flow reflects a company's stage in its life cycle and the external environment, including the tax code (NB: for this reason, tax should also be included in operating profit, see discussion in question 6). Investments can be extremely lumpy, even if they just relate to replacement assets. For example, a company might have operating assets such as aircraft with a 20-year life. If the company is not extremely large, the year when one of these assets get replaced will be hugely cash negative (whereas investment may be close to zero for many years thereafter), reflecting the investment made, rather than a change in the operating environment. Consequently, the investment should be reflected in investing cash flow.

In addition, the preparers may encounter difficulties in determining which cash flows relating to PP&E should be reported as operating and which as investing. Depending on the business model, the distinction can be completely arbitrary, even meaningless

We recognise that it can be a source of frustration for preparers that Free Cash Flow (FCF), which is effectively operating cash flow less investment and represents a useful measure of cash flow available for discretionary spending in the period, cannot be shown on the face of the financial statements. However, the remedy would be either to show FCF in a separate section, or to make a case to the IASB that companies should be allowed to show it as a subtotal below operating cash flow, but before the total for investing cash flow. For an analyst, it's not a problem to insert this subtotal into their own models, as long as the information is provided somewhere in the annual or quarterly report.

Question 5

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

We believe that all cash flows relating to financing activities should be reported in the financing section of the cash flow statement with a clear split between interest and principal where possible. CRUF participants do not normally consider interest payments, except for any arising from contracts with customers, as an operating cash flow when looked at through the lens of an Enterprise Value led approach in which operating cash flows are used to service all financial stakeholders both in terms of return on and of their capital. Therefore, interest payments should be treated as financial cash outflows to remain distinct from the treatment of the dividends paid, which is the cost from equity finance. While IAS 7 leaves the treatment of interest paid at the discretion of preparers, this prejudices the comparability of cash flow statements.

The CRUF would also welcome better disclosure for companies with material leasing activities, which can grossly distort cash flow. There is a debate about whether the cash cost of 'buying' your own products to lease to users is an operating item or a financial one, but the important issue here is making it possible for investors to understand what is happening.

Question 6

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

There were mixed responses to this question also. In some respects governments are stakeholders in a business who are serviced by the operating cash flows and again it follows that tax payments, which remunerate this special class of stakeholder, should be seen as a separate flow. We also agree with the observation that an allocation to specific sections of the cash flow or profit or loss statements can be highly arbitrary. As we noted in our May 2009 letter to the IASB and FASB for the Financial Statement Presentation Project (FSP), we find that understanding the link between tax payments and the tax charge in the Income statement is often impossible.

An alternative point of view is that taxes are a fact of life and reduce the cash you can generate from running your business. Therefore, operating cash flow before taxes is a fairly meaningless number for investors and cannot serve as the basis for valuing equity or debt instruments. If taxes were stripped out of operating cash flow, analysts would then have to make their own adjustments to add them back in to get to a cash flow metric that is indicative of the earnings power that investors can rely on to repay debt or generate equity value. Of course, companies should be allowed to allocate portions of taxes paid to the investment and financing sections of the cash flow statement where the taxes clearly arise as a result of those, however, in practice, such situations may be difficult to identify, in which case it is fine to allocate all cash taxes paid to operating cash flow. There should be a separate line in the operating cash flow to indicate the amount of cash taxes paid, i.e. tax paid should never be included in "Other".

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?

CRUF participants generally believe that “cash” is not a particularly useful measure in valuation or in assessment of the performance of a company unless there are concerns over going concern. It is for this reason that we tend to prefer to see a company define net debt and then clearly reconcile opening and closing net debt positions. During the financial crisis we note that cash, which typically includes current accounts, was not always totally liquid or safe and many corporations held physical gold to ensure that they had a fungible, instantly accessible asset to settle obligations in the event of a bank failure (accepting price volatility as cost of doing this). However, recognising that consistency of definitions is key to create a uniform starting point for all entities, we accept that only including cash is perhaps better than adding cash equivalents, provided that net debt is also defined and a reconciliation provided.

Question 8

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

CRUF participants do not have strong views on net presentation as they have encountered relatively few issues which affect their analysis of company performance. It is worth noting that this is more likely to have implications where the going concern principle may not be appropriate and therefore there should be less scope for net presentation in such instances. It would be most useful to have a clear disclosure of the timing of future cash flows relating to financial obligations and asset maturities.

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?

CRUF participants strongly believe that the reconciliation is always necessary between operating profit and gross operating cash flow but do accept that the location is not that important as long as it is readily found. We would observe, however, that many users do believe that the reconciling items are short-cuts to quasi-cash flows. For example increases or decreases in inventory, trade debtors or creditors may be more intuitively meaningful for users instead of the gross purchases or receipts.

Question 10

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

Most CRUF participants have consistently expressed a preference for indirect cash flow statements but would not object to a direct statement being permitted as well. Most arguments in favour of a direct cash flow statement point to the belief that it helps with predicting future cash flows but on the whole this is equally true of the indirect method when correctly structured around an enterprise value approach.

We do believe that many direct cash flow items are needed and in addition would always ask for the following:

- Direct cash flows for all items outside Operating Cash flow including pension deficit reduction payments, capital lease payments, and any cash flows relating to exceptional items.
- A reconciliation of changes in Net Debt identifying the impact of cash flows, M&A, non-cash changes, and FX.
- Details of hedging so that the company's exposure to changes in interest rates, FX and other external risks can be clearly understood, in cash flow terms as well as in the statement of Profit and loss and Other comprehensive income (OCI).
- Separate identification of cash flows relating to discontinued operations, including prior year numbers.

CRUF participants also believe that the debate between direct or indirect is a bit sterile as the direct method usually includes some indirect headings and vice versa. The overall objective is the important thing, which is to present a cash flow statement that helps investors and other stakeholders understand the way that the

enterprise generates and uses cash. Capex and tax should usually be direct but we prefer the opening number to be a measure of operating profit that must then be reconciled to cash requiring an indirect step.

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?

This is clearly a complex issue for standard setters as it is not possible to come up with a clear definition which can be consistent for all companies as material items will vary depending on the nature of the operating activities and duration of working capital cycles and asset lives for the reporting entity. We also recognise that multi-segment companies operating in multiple currencies and those which have participated in material merger and acquisition activities create a real issue in this respect. CRUF participants would tend to point to defining materiality and asking management and the audit committee to consider what information is most relevant. The question that users want to answer is to determine what level of fixed and working capital will be absorbed (or in some cases released) for a given level of growth and whether there are one off timing differences which make the current year cash flow unrepresentative of the long run cash generation of the business for any given level of profitability.

As an illustration to the above, many CRUF participants have highlighted that they have particular trouble with companies that 1) have large advance payments or 2) have embedded leasing/financial services subsidiaries. If this is material for a company then additional disclosure should be encouraged as it usually meets the threshold of material information.

We also find that spending against provisions can be opaque. Movement in provisions is usually a mix of direct (e.g. cash spending against a restructuring provision) and other unspecified indirect movements. One of the better aspects of the FSP project was that it required a reconciliation between opening and closing provisions.

Also, the use of 'movement in other liabilities' should be discouraged as it is utterly impenetrable.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF was set up in 2005 by users of financial reports to be an open forum for learning about and responding to the many accounting and regulatory changes that affect corporate reporting. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters and regulators. CRUF participants include buy and sell-side analysts, credit ratings analysts, fund managers and corporate governance professionals. Participants focus on equity and fixed income markets. The Forum includes individuals with global or regional responsibilities and from around the world, including Australia, Canada, France, Germany, Hong Kong, India, Japan, New Zealand, South Africa, UK and USA.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. In our meetings around the world, we seek to explore and understand the differences in opinions of participants. The CRUF does not seek to achieve consensus views, but instead we focus on why reasonable participants can have different positions. Furthermore, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. This response is a summary of the range of opinions discussed at the CRUF meetings held globally. Local country differences of opinion are noted where applicable.

Participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. Accordingly, we sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum and not as representatives of our respective organisations. The participants in the Forum that have specifically endorsed this response are listed below.



(Signatures)

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