Association of Accounting Technicians response to the Financial Reporting Council (FRC) consultation document “Improving the Statement of Cash Flows”

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1. Introduction

1.1. The Association of Accounting Technicians (AAT) is pleased to have the opportunity to respond to the FRC consultation document "Improving the Statement of Cash Flows", published on 20 October 2016.

1.2. AAT is submitting this response on behalf of our membership and for the wider public benefit of ensuring that the financial reporting framework used in the UK is fit for purpose, up to date, and results in decision-useful information in financial statements.

1.3. AAT has added comment in order to add value or highlight aspects that need to be considered further and particularly focused on whether the proposals meet the above objectives and are proportionate.

1.4. In preparing this response AAT has considered the potential impact that the proposed changes would have on SMEs, many of which employ AAT members or would be represented by AAT's 4,250 licensed accountants.

2. Executive summary

2.1. **AAT agrees that cash flow information is of importance to investors and other stakeholders and that the changes proposed would enhance the value of the statement of cash flows.**

2.2. **AAT believes that the statement of cash flows should only report cash flow information**. Any reconciliation that may include non-cash flow information (such as the reconciliation of net cash flows from operating activities) should remain outside of the main body of the statement.

2.3. **AAT does not agree that notional cash flows should be reported in the statement of cash flows**. This would impede the usefulness of the report as users expect it to be prepared on a cash basis.

2.4. **AAT supports the reasons for reclassifying capital expenditure from investing activities to operating activities.** This expenditure supports the business's operating activities as noted in paragraph 2.6 of the discussion paper.

2.5. **AAT's view is that the definition of 'cash' itself could include the example of a bank overdraft for clarity.**

3. AAT response to the consultation document

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

3.1. Cash flow information is critical to investors and other stakeholders and so AAT fully supports the stance that IAS 7 *Statement of Cash Flows* takes where this information is concerned as noted in paragraph 1.1 of the discussion paper. Investors and stakeholders are particularly interested in how a company generates and expends cash, which may not be immediately apparent from the other primary statements, such as the income statement and the statement of financial position.

3.2. AAT agrees with the notion in paragraph 1.17 of the discussion paper that cash flow information is valuable as it provides an alternative perspective on information by virtue of the linkage of the statement of financial position and income statement. AAT agrees that accruals information does provide superior information on performance compared to information concerning cash flows (paragraph 1.20 of the discussion paper). While cash flow information is crucial to investors and other users of the accounts, accruals information provides a clearer and more representative view of the reporting entity's performance rather than a cash-based statement. Linked to this notion is the effect on the entity's statement of financial position which reflects the amounts owed to the entity in the form of debtors and pre-payments and amounts owed by the entity in the form of creditors and accruals. This informs the users of the financial statements as to the cash inflows expected to be received by the entity in the succeeding accounting period and the cash outflows expected to be paid by the entity.

3.3. AAT also agrees with paragraph 1.22 of the discussion paper which confirms that cash flow information can assist users in their understanding of performance due to the different perspective it places on an entity's operating activities. Investors and users need information about an entity's profitability and liquidity in order to consider investment prospects. A reconciliation of profit per the income statement to net cash flows generated from operations provides the basis of the information by explaining the relationship between an accruals-based performance measure to a cash-based one (i.e. by adjusting profit or loss for the period for the effects of non-cash transactions and increases in working capital).

3.4. AAT concludes that cash flow information is of vital importance to investors and stakeholders and such information should be provided in as clear and concise form as possible. Doing so enables an understanding of how an entity has generated cash and how it has spent that cash in the period.

Question 2: Do you agree that notional cash flows should not be reported in the statement of cash flows, but that non-cash transactions should be transparently disclosed? If notional cash flows should, in your view, be reported, how would they be identified?

3.5. AAT does not agree that notional cash flows should be reported in the statement of cash flows. In our view, this would impede on the usefulness of the statement of cash flows which, by definition, users would expect to be prepared on a cash basis (cash inflows less cash outflows). AAT agrees with the point made in paragraph 1.32 of the discussion paper that it is desirable that non-cash transactions are transparently reported within the financial statements (as currently required by paragraphs 43 and 44 of IAS 7). While paragraphs 43 and 44 of IAS 7 limits such non-cash transactions to investing and financing cash flows, AAT agrees that there is a case for extending this requirement for all non-cash transactions, including those related to operating activities (paragraph 1.32 of the discussion paper).

3.6. AAT is of the opinion that confining the disclosure of non-cash transactions to investing and financing cash flows, per paragraphs 43 and 44 of IAS 7 seems incomplete and investors would find it more useful to have additional disclosure of non-cash transactions in respect of operating cash flows. AAT's opinion is also accentuated by the views of investors contained in the Financial Reporting Lab's report *'Operating and investing cash flows'* referenced in paragraph 1.32 of the discussion paper.

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

3.4. The structure of the statement of cash flows into operating, investing and financing activities does work reasonably well in practice (paragraph 2.1 of the discussion paper). In AAT's view, the definition of operating activities being *'… the principal revenue-producing activities of the entity and other activities that are not investing or financing activities'* is fairly well understood and in a significant majority of cases, the classification of cash flows is clear-cut. The current definition of operating cash flows has given rise to this category of cash flow classification becoming a 'default' category, as described in the discussion paper at paragraph 2.3, i.e. if the cash flow does not meet the definition of investing or financing

activities, it is included within operating activities by default. AAT agrees with the discussion paper at paragraph 2.3 that this principle does raise some concerns given the importance that investors place on cash flows from operating activities. As this cash flow classification would, in the eyes of investors, be considered a central cash flow due to the fact that, in the majority of cases, it is the main area in which entities generate and expend cash.

3.5. The discussion paper cites an example in paragraph 2.3 of a hostile takeover which, under IAS 7 as currently drafted, would fail to be classed as an operating activity because the cash outflows to defend the takeover is neither a financing or investing cash flow. One would expect such cash flows to be fairly infrequent in nature and hence if it is masked within operating activities, investors may be unaware of any previous hostile takeover attempts. AAT would, therefore, agree that the definition of operating activities be positively defined or described.

3.6. AAT agrees with paragraph 2.4 of the discussion paper that any attempts to redefine or describe operating activities should make clear that the category should not exclude cash flows simply because they are unusual or non-recurring. However, AAT would also suggest that additional clarification is included within any definition or description so as to be clear as to when such cash flows should be separately disclosed on the face of the statement of cash flows. AAT would suggest that reference be made to the materiality of the cash flow in question; thus, if the cash flow(s) in question is deemed to be material to a user's understanding, then it should be shown separately (as shown in the recast statement of cash flows in Appendix B of the discussion paper on page 36).

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'?

3.7. AAT supports the reasons for reclassifying capital expenditure from investing activities to operating activities. This is because such purchases are required to support the business's operating activities as noted in paragraph 2.6 of the discussion paper. For example, a manufacturing company that is plant-intensive will often replace items of machinery to continue or enhance its manufacturing and production processes. While some commentators would argue that such items should be classed as investing activities, given the nature of the cash outflows in substance, AAT would view these cash flows as a means of contributing to the entity's profit. As a result they should be regarded as cash flows from operating activities.

3.8. AAT does not support the view of mandatory classification between replacement and expansion expenditure (paragraph 2.13(a) of the discussion paper). This classification would place an unnecessary burden on reporting entities, particularly those which have a high level of capital expenditure programmes each year. The requirement to disclose the basis of allocation would also prove to be arduous for reporting entities.

3.9. AAT would favour the proposal in paragraph 2.13(b) of the discussion paper which would require all capital expenditure to be reported in an entity's statement of cash flows from operating activities and then to encourage the entity to separately distinguish between the two classes of capital expenditure. This would avoid any unnecessary complexities, in what is already a fairly complex statement to prepare, as well as avoiding the need to interpret and define 'replacement' and 'expansion' capital expenditures (paragraph 2.15 of the discussion paper).

3.10. AAT supports the view in the discussion paper at paragraph 2.16 that separate disclosure is needed where expenditures on property, plant and equipment is concerned because these will, in a majority of cases, be sizeable in terms of monetary amount and nature and to mask them within the operating activities cash flow classification would be unhelpful and misleading to investors and stakeholders.

3.11. AAT agrees with the notion that when an entity acquires another entity in a business combination, as defined in IFRS 3 *Business Combinations*, it would be expected that such a cash flow would be regarded as an investing activity and separately disclosed as such -

as illustrated in the recast statement of cash flows in Appendix B of the discussion paper. In most situations, it is clear when a business combination has taken place and hence cash flows associated with this transaction would be classed as an investing activity. It is also equally clear when a reporting entity has merely acquired assets and liabilities and such transactions can be clearly distinguished by reference to the sale/purchase agreement. AAT is of the opinion that all purchases of assets should be consistent regardless of whether they are purchased from a supplier or acquired through an asset/liability purchase and hence fall to be treated as operating cash flows.

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

3.12. AAT agrees with the view that imputed cash flows must be ignored for the purpose of the statement of cash flows (paragraph 2.27 of the discussion paper). To bring in the concept of imputed interest for cash flow purposes would not only confuse preparers and users, but also detract from the usefulness of the statement of cash flows itself. AAT also does not support the view in paragraph 2.28 of the discussion paper where the sale of goods for deferred payment should be regarded as a non-cash investing activity and receipt from the financial instrument received should be reported as investing cash flows. Not only are these types of transactions extremely rare in practice, but in our view they would add unnecessary complexity to the standard.

3.13. AAT supports the view in paragraph 2.29(a) and (b) which distinguishes between sales on normal credit terms and sales of assets in exchange for separate financial assets because this approach appears to be the most sensible. Normal trading sales on credit would be classed as operating cash flows, which is no different to the present version of the standard; whereas financing transactions involving the sale of assets in exchange for a separate financial asset would be reported as investing cash flows. The distinction between these two types of cash flows is clear; where a company sells goods on credit to a customer, that sale is concluded in the ordinary course of business and hence should be regarded as an operating cash flow. Where the seller sells an asset in exchange for a financial asset, the seller would, in substance, be undertaking this transaction for investment purposes and hence the cash flow should follow its substance into the statement of cash flows and be classed as an investing cash flow.

3.14. AAT agrees with the proposals set forth in paragraphs 2.31 (i) to (iii) of the discussion paper concerning financial liabilities and the classification of the cash flows in the transaction. Financial liabilities will give rise to both interest and capital cash outflows. Where a reporting entity obtains a loan to finance the acquisition of an asset, the loan proceeds should be classed as financing cash flows because, in substance, that represents the characteristics of the cash flow; in other words, the reporting entity has received proceeds to fund the acquisition of an asset which is akin to a loan. The cash flows used to acquire the asset will be paid out of the loan proceeds, but should still be reported as operating activities because, invariably, the entity will acquire an asset for use in its business which will contribute to operating cash flows.

3.15. With regards to the payment of interest, currently these are shown within net operating cash flows, albeit they are disclosed separately. AAT's view is that this treatment is inconsistent with the substance of the transaction concerned. Interest paid by a reporting entity arises as a direct consequence of a financing cash flow (i.e. the raising of capital, which is classed as a financing cash flow). In our view, it should follow that as interest is a by-product of the capital amount raised in the loan, interest should be classified as a financing cash flow and not as an operating cash flow. In previous UK GAAP at FRS 1 *Cash flow statements (revised 1996)*, interest payments arising as a result of financial liabilities were included within a separate section 'Returns on investments and servicing of finance' which was, in our view, a logical classification. AAT therefore supports the proposal that payments to providers of debt finance, including interest payments, should be classified as financing activities.

3.16. AAT agrees with the comments made in paragraph 2.33 of the discussion paper relating to the classification of dividend cash flows. Dividends are paid to shareholders as a return on their investment. A company raises finance through the issuance of shares, which are classified as financing cash flow. It is somewhat illogical to have dividends on those

shares reported in a different section of the statement of cash flows (i.e. within operating activities). While the cash paid to the shareholders in respect of the dividend may have been generated from operating activities, the substance of the cash flow itself is that of a payment in respect of the shareholders' return and hence the most sensible classification of this cash flow would be within financing activities.

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

3.17. AAT supports the proposal to deal with taxes paid/received in a separate section of the statement of cash flows. In most cases, taxes paid or received are included within net cash from operating activities, albeit they are disclosed separately for clarity. Under previous UK GAAP at FRS 1, a reporting entity was required to show the amount of tax paid or received in a separate part of the cash flow statement, under the 'Taxation' cash flow classification. This approach did not appear to cause any undue difficulties or appear to be considered as arduous by reporting entities.

3.18. As IAS 7 currently requires a reporting entity to include tax cash flows within net cash from operating activities, it would merely involve moving the tax cash flows from one area of the statement of cash flows to another. This is unlikely to prove onerous or costly on the part of a reporting entity. It would also be useful to investors as noted in paragraph 2.39 of the discussion paper.

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?

3.19. AAT supports the points raised in paragraph 3.9 of the discussion paper which suggest that cash equivalents are both arbitrary and subjective. Cash equivalents are not cash, regardless of how the definition is interpreted. To that end, AAT agrees with the comments in paragraph 3.11 of the discussion paper that, in substance, the term 'cash' can only represent cash that the reporting entity has on hand or has immediate access to in a bank account (whether a current or deposit account). Cash equivalents can have several characteristics; some may be able to be realised in cash in a relatively short timeframe, whereas others may need some lead time to convert (for example where a bank may need to be given notice before the cash equivalent is drawn). Such investments would still be regarded as cash equivalents under the current IAS 7.

3.20. The statement of cash flows should only report movements in cash during the reporting period. As the discussion paper states at paragraph 3.13, the guiding principle where cash is concerned is that cash, whether held in a current or deposit account, can be used to pay expenses incurred in the ordinary course of business and also enables the business to meet financial obligations; something which cash equivalents usually (if not always) do not do.

3.21. AAT is generally supportive of the revised definition of 'cash' in paragraph 3.13 of the discussion paper, although AAT's view is that the definition itself could bring in the example of a bank overdraft for clarity, so that the definition would read:

'Cash comprises cash on hand, and deposits with and advances from banks and similar financial institutions that are repayable on demand such as a bank overdraft.'

3.22. The inclusion of a bank overdraft within the definition would give weight to the idea that bank overdrafts would always form part of the entity's cash management rather than the way in which the standard is currently drafted which suggests that bank overdrafts are only included in cash and cash equivalents when the overdraft forms an integral part of an entity's cash management. In almost all (if not all) cases, it can be said that an overdraft would always form part of an entity's cash management.

3.23. AAT believes that if the definition of cash is amended, as suggested by the discussion paper, with the potential inclusion of a bank overdraft brought into the definition itself, cash equivalents would, by default, fall out of the scope of cash and would have a standalone function within the standard.

3.24. The definition of 'cash equivalents' currently suggests that these are investments that are subject to an insignificant risk of change in value. Paragraph 3.11 of the discussion paper which questions whether any investments are, in fact, equivalent to cash should have some relevance to this definition because a sudden change in the credit environment will more than likely have a significant effect on the investment. It is therefore difficult to see how, say, a three-month investment could be regarded as having an insignificant risk of change in value when compared to, say, an investment that could be converted into cash within 24-48 hours. In the latter case, it would be reasonable to expect the investment to not change in value significantly.

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

3.25. AAT does share the concerns raised about the vagueness of paragraph 22b of IAS 7 (reproduced in paragraph 3.26 of the discussion paper). What one entity may determine as 'quick' may be quite different to what another entity may determine as such. Similarly, what one entity may regard as 'short' may not be perceived in the same way by another. There is, therefore, potential for divergent practice to arise in this respect, although, as noted in paragraph 3.27, the potential for this has not been widely noted. At present, AAT does not regard any change as being necessary unless divergent practices start to emerge.

3.26. AAT does have concerns where netting-off is concerned and would only support net presentation for financial instruments that are in the class suggested in paragraph 3.31 of the discussion paper. AAT would not support the off-setting of the purchase of one type of investment against the sale of a different type of investment because, in AAT's view, this would be misleading to investors. There must be a strict rule where off-setting is concerned to ensure that investors and stakeholders are provided with information that is meaningful and assists them in the decision-making process.

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?

3.27. AAT supports the presentation of a reconciliation of operating activities and agrees that it is important for the reasons set out in paragraph 4.3 of the discussion paper.

3.28. AAT has not encountered any issues with members concerning the location of the reconciliation of operating activities and supports the underpinning reasons why the reconciliation itself is not considered to form part of the statement of cash flows. Indeed, the indirect method of preparing the statement of cash flows involves adjusting profit for the effects of non-cash items. To include such a reconciliation within the statement of cash flows would detract from the overall concept of the statement, which is to show how an entity has generated and spent cash. Bringing non-cash items onto the face of the statement of cash flows would not be appropriate and would potentially be misleading. For this reason, AAT does not concur with the dissenting members in paragraph 4.9 that a separate schedule reconciling operating activities would be 'confusing and counter to the primary purpose of a statement of cash flows.' AAT's view is, in fact, the opposite.

3.29. AAT would not support any proposals to bring the reconciliation onto the face of the statement of cash flows and hence supports the conclusion in paragraph 4.13 of the discussion paper that it should remain as a supplementary note to the statement itself.

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

3.30. In practice, the indirect method of preparing the statement of cash flows is the most common, largely because it is less complex to prepare than the direct method. AAT is unaware of any stakeholders that have expressed disapproval of reporting entities preparing a statement of cash flows under the indirect method as opposed to the direct method. Both the direct and indirect methods of preparing the statement of cash flows are well-established in GAAP.

3.31. AAT is of the opinion that a reporting entity should be free to choose which method of preparation they adopt for the statement of cash flows, provided they are consistent from one period to the next and that any changes from the direct method to the indirect method (or vice versa) is treated as a change in presentation under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This would, of course, require the change to be applied retrospectively to the previous statements of cash flows reported in the financial statements.

Question 11: Which components of cash flows from operating activities should an accounting standard identify as particularly significant, and why? How would standard-setters decide whether to require disclosure of the amount of such components or of changes in related working capital items?

3.32 Changes in working capital are currently contained within the reconciliation of operating activities which is not disclosed on the face of the statement of cash flows. AAT is of the opinion that this should not be subject to any changes. Cash collected from customers is a useful figure, used in financial analyses, and the direct method of preparing the statement of cash flows would disclose this figure. For those entities that choose to prepare the statement of cash flows under the indirect method, obtaining figures in respect of cash collected from customers where an entity uses IT as a means of manging their accounts may be as simple as extracting a report from the accounting records. However, in some cases it may not be as straightforward and paragraph 5.10 of the discussion paper highlights some of the practical difficulties that entities might face; particularly those that prepare a statement of cash flows under the indirect method.

3.33 Certain cash flows are more material than others. For example, in an academy school, staff salaries are often the largest expense of the school, but are not separately reported in the statement of cash flows. While cash received from customers is, in most cases, a significant cash inflow over a reporting period, in some entities it may not be. It would be difficult for standard-setters to 'pinpoint' which cash flows should require separate disclosure because all industries and entities are different. If changes are made to the statement of cash flows which would result in additional operating cash flows being separately disclosed, materiality issues (both qualitative and quantitative) may have to be considered.

3.34 The question in paragraph 5.11(ii) asks whether a detailed reconciliation of the working capital amounts is required. To a large extent, these amounts would already be shown in the notes to the financial statements and therefore to repeat these as a supplementary note to the statement of cash flows would duplicate that information. A potential (and probably better) solution would be to cross-reference these amounts to the notes contained elsewhere in the financial statements.

4. About AAT

4.1. AAT is a professional accountancy body with approximately 50,000 full and fellow members and 90,000 student and affiliate members worldwide. Of the full and fellow members, there are over 4,250 licensed accountants who provide accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types.

4.2. AAT is a registered charity whose objectives are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

5. Further information

If you have any questions or would like to discuss any of the points in more detail then please contact Aleem Islan, AAT Technical Consultation Manager, at:

E-mail: consultation@aat.org.uk Telephone: 020 7397 3088

Association of Accounting Technicians
140 Aldersgate Street
London EC1A 4HY