Cash flow statement

Supervision of Financial Reporting

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Contents

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The Netherlands Authority for the Financial Markets (AFM)

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. We promote the fair and conscientious provision of financial services to consumers and private investors, as well as professional and semi-professional parties. We supervise the fair and efficient operation of the capital markets. Our aim is to improve consumers’ and companies’ confidence in the financial markets, both in the Netherlands and abroad. In performing this task, the AFM contributes to the stability of the financial system, the economy and the reputation and prosperity of the Netherlands.

1 Management summary

In times of persistently moderate economic growth and prospects, investors focus more on the ability of companies to generate positive cash flows. The AFM has established in recent years that the cash flow statement is the element of the financial statements with the most shortcomings. For this reason, six years ago the AFM conducted a thematic review of the cash flow statement for 2006 and returned to this theme last year. The review was carried out on the cash flow statement as included in the 2012 financial statements of 46 listed companies. In this review, the AFM focused on three quality features of financial reporting: comprehensibility, comparability and faithful representation.

A company's continued existence depends on its ability to generate positive cash flows. The cash flow statement provides the following information to users of the financial statements:

- The operational cash flow shows the profit and loss on a cash basis;
- The investment cash flow shows only the changes in the non-current assets on a cash basis;
- The financing cash flow shows only the movements in funding, namely the non-current liabilities and the equity on a cash basis.

The AFM calls on companies to remember this objective when preparing their cash flow statements.

The main findings of the review are:

- Comprehensibility: companies are making an effort, but there is room for improvement;
- Comparability: extensive freedom of choice means that company-specific accounting policies are needed;
- Faithful representation: still under pressure.

Comprehensibility: companies are making an effort, but there is room for improvement

To be able to understand the cash flows presented in the context of the financial statements, it is important that the elements in the cash flow statement relate to other elements in the financial statements. For this reason, IAS 7 (Statement of Cash Flows) makes reconciliations mandatory and urges that extra information should be provided. Moreover, research shows that users also have other information requirements. These include a reconciliation with the change in the net debt position, visibility of cash flows associated with extraordinary transactions and cash flow information per segment. Most of the companies provide this information to some extent, but there is certainly room for improvement.

Comparability: extensive freedom of choice means that company-specific accounting policies are needed

Companies must present their cash flows from operating, investment and financing activities in a way that is most appropriate to their activities. To make this possible, IAS 7 offers freedom of choice with respect to classification for various items. The AFM notes there is considerable variety with regard to the presentation of various items, including the classification of dividend received and what is treated as ‘cash’ and what is not. This makes it difficult for investors to make well-considered decisions. In fact, they must be able to compare cash flow information from various companies in order to make good decisions. Information on the choices made is therefore important. This information should be based on an accounting policy that reflects specific features of the company. A large majority of the companies state an accounting policy, however in most cases this is generic in nature (‘boilerplate’) and contains little company-specific information. This makes it difficult for users to interpret the information in the cash flow statement.

Faithful representation: still under pressure

The cash flow statement should only show actual cash flows presented in the correct category. The number of breaches of the provisions of IAS 7 on this point has fallen in comparison to the review of six years ago. Since any material breach potentially can lead to an ill-informed investment decision, further improvement is needed here. The AFM thus calls on all preparers to exercise greater care when preparing the cash flow statement.

2 Rationale, objectives and population

2.1 Rationale

The cash flow statement becomes more important to the extent that the financial situation does not improve. If cash is scarce, companies will increasingly need to monitor their cash flows. For this reason, in most studies the cash flow statement is considered to be one of the most important elements in the financial statements. The increasing attention on the generation and monitoring of cash flows by companies and their liquidity position has led to greater focus on the cash flow statement by users of financial reporting and supervisors.

The cash flow statement must present a 'true and fair view' of incoming and outgoing cash flows. On the basis of its desktop reviews, the AFM has established that the cash flow statement is the element with the most shortcomings in recent years. For this reason, six years ago the AFM conducted a thematic review of the cash flow statements for 2006 and returned to this theme last year.

2.2 Objectives: are the cash flow statements comprehensible and comparable, and do they give a faithful representation?

The thematic review of cash flow statements is intended to obtain information with respect to the following quality features of financial reporting as described in the Conceptual Framework:

- Comprehensibility: to be able to understand the cash flows presented in the context of the financial statements, it is important that the elements in the cash flow statement relate to other elements in the financial statements, such as the statement of financial position. Both mandatory reconciliations (the reconciliation of the cash position with the statement of financial position and discontinued operations) and voluntary reconciliations (net debt reconciliation and segment information) were reviewed.
- Comparability: IFRS allows freedom of choice with respect to various items. What options have companies chosen, and to what extent does the choice made affect the comparability of the cash flows with other companies in the same index or industry? Under this theme, a further review was made to establish which items form part of the 'cash' item and which variable companies use as the reference point for the operational cash flow prepared according to the indirect method;
- Faithful representation: this theme mainly involved consideration of whether the cash flows presented concern actual cash flows and whether the cash flows that have to be presented in a certain category are indeed included in this category.

We also considered the development in quality of the cash flow statement. In 2007 the AFM reviewed the application of the provisions for the statement of cash flows (IAS 7) in the financial reporting for 2006. We looked at the extent to which the considerations in the reporting of this thematic review were taken account of in the financial reporting for 2012. These mainly concerned: the incorrect inclusion of other (non-cash) changes in the investment and financing cash flows, the absence of accounting policies for cash flow statements and the wide variety in the reference points used for the indirect operational cash flow.

2.3 Population: 46 companies

The Cash Flow Statement thematic review was conducted on the 2012 financial reporting of public companies incorporated under Dutch law whose shares are listed on a regulated market in the Netherlands. Companies in the financial sector (banks and insurers) were left out of consideration. We randomly selected ten companies from each index (AEX, AMX and ASCX) and twenty companies listed locally. The selection included three companies that do not prepare their financial statements on the basis of IFRS and one company that had not (or not yet) prepared its financial statements for 2012. These four companies were accordingly left out of consideration and our review comprised 46 companies.

3 Key review results

The findings are shown in groups for each quality feature. The comparison of the findings of the thematic review on 2006 with the present review is included with the quality features in question.

3.1 Comprehensibility: companies are making an effort, but there is room for improvement

A majority of the companies reviewed are striving to make the information in their cash flow statement comprehensible to users of the financial statements. There is however room for improvement in this respect. To be able to understand the cash flows presented in the context of the financial statements, it is important that the elements in the cash flow statement relate to other elements in the financial statements, such as the statement of financial position. To achieve this, IAS 7 makes certain reconciliations mandatory and also encourages companies to provide extra information. The AFM has checked to establish the extent to which companies are complying with the requirements of IAS 7. We have also reviewed the literature with respect to the information required by users of the financial statements on this point. A summary of the extent to which companies are meeting these obligations and needs is given below.

The AFM encountered the following information and reconciliations in the financial statements reviewed with relative regularity:

- a reconciliation between the amounts in the cash flow statement and the corresponding items in the statement of financial position (95%), which is mandatory under IAS 7.45;
- a separation between cash flows relating to intangible non-current assets and property, plant and equipment (72%);
- references to the disclosures of items in the cash flow statement (67%);
- information on financing facilities available but not taken up (63%), the provision of which is encouraged by IAS 7.50.a.

The AFM encountered the following information and reconciliations with significantly less regularity:

- 43% of the companies determining their operational cash flow using the indirect method showed the changes in the net working capital per item in the statement of financial position separately. In going through the cash flow statements, the AFM noted that several companies made a visual distinction between the changes in net working capital and the other adjustments to the result. This improves clarity;

- Only 9% of the companies showed a reconciliation between the change in the net debt position and the net cash flows, including the effect of debt in acquired or divested companies and exchange rate differences;
- Only 4% of the companies made a separation between the investment due to replacement and investment for the purpose of expansion. IAS 7.50.c encourages companies to provide this information;
- Only 4% of the companies presented cash flows relating to unusual or extraordinary transactions separately;
- Only 3% of the companies with more than one segment showed the cash flow information for each segment. IAS 7.50.d encourages companies to provide this information.

The reconciliation between the cash flow statement and the statement of financial position (IAS 7.45) is mandatory for all companies and must always be included in the financial statements. The AFM, moreover, urges companies to include the above-mentioned points in their financial reporting for 2013. Companies will thus meet the needs of the users of their financial statements.

3.2 Comparability: extensive freedom of choice means that company-specific accounting policies are needed

Cash flow statements of different companies are not easily comparable. The reason is that IAS 7 offers extensive freedom of choice to companies with regard to presentation. Companies must present their cash flows from operating, investment and financing activities in a way that is most appropriate to their activities. This method of classification provides information whereby users can form an impression of the impact of these activities on the financial position and the cash and cash equivalents at the company's disposal. This information can be used to understand the mutual relationship between these activities.

Investors can choose between alternatives. This means that it must be possible to compare the information on one company with the information provided by other companies. This is why it is important that users understand the choices a company has made in the preparation of its cash flow statement. Information on these choices should be stated as an accounting policy for the cash flow statement.

The AFM notes that the greatest variety concerns:

- the decision by companies regarding what constitutes cash and cash equivalents (such as prepayments in current account and time deposits); and
- the classification of dividend received.

Companies are more consistent on the following points:

- the choice of an indirect cash flow statement and the reference point for this; and
- the classification of dividend paid.

Most of the companies state all or some of the choices they have made in an accounting policy. In most cases, however, the policy is stated in generic terms ('boilerplate') and contains little company-specific information, meaning it is difficult for users to interpret the information in the cash flow statement.

Indirect versus direct cash flow statement

Despite the preference of the International Accounting Standards Board (IASB) for a cash flow statement prepared according to the direct method, 89% of the companies use the indirect method. This is a small change compared to six years ago, when 100% of the companies reviewed prepared their cash flow statement according to the indirect method. One of the companies that did prepare its cash flow statement using the direct method stated the calculation of the operational cash flow according to the indirect method in its disclosures to the financial statements. This initiative positively affects comparability with its industry peers.

Even if the operational cash flow is determined indirectly, the cash flow statement must be based on actual or in any case approximated cash flows. Determining a cash flow statement indirectly cannot be the same as looking for reconciliation with the changes in the statement of financial position at line level, since this does not in all cases lead to the cash flow or an approximation thereof. One of the advantages of determining the operational cash flow using the indirect method is that this type of cash flow statement shows the net differences between the operating result and the cash flow of operating activities. Investors use this information to form an opinion regarding the quality of earnings and in order to obtain a better understanding of the company's ability to generate positive cash flows from 'ordinary activities'.

Companies calculating their operational cash flow using the indirect method use the following reference points in their 2012 financial statements:

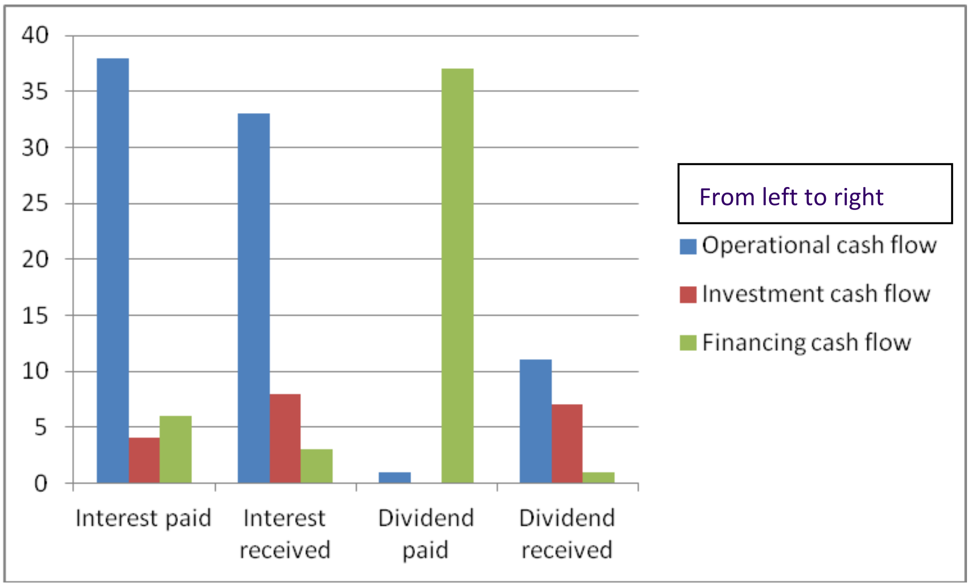
- result after tax (53%);
- result before tax (27%);
- EBIT (earnings before tax and interest) (17%);
- EBITDA (earnings before tax, interest, depreciation and amortisation) (3%).

This variation in reference points is more or less the same as in the review conducted six years ago.

Classification

IAS 7 offers freedom of choice as regards the classification of various items. Based on the presentation of interest and dividend in the cash flow statement, the AFM has listed the categories in which companies present these items. The findings are shown in the figure below. Since some companies present an item in more than one category, not all the items add up to 46. It is notable that the variation in the presentation of dividend received is much greater than for the other items.

Figure 1: classification of cash flows



Accounting policies

The AFM found a description of the accounting policy applied in more than 84% of the companies. This represents an improvement compared to six years ago, when only 60% of the companies included an accounting policy for the cash flow statement in its 2006 financial statements. The main accounting policies found by the AFM in the 2012 financial statements were:

- the choice of direct or indirect method (65%);
- the choice of which items are treated as cash and cash equivalents (52%);
- the choice of classification of interest (35%);
- the choice of classification of dividend paid (26%);
- the choice of classification of tax (22%);
- the choice of classification of dividend received (11%).

Given the variety of cash management and banking agreements around the world, a company is obliged to state the accounting policies it applies for the determination of the components of cash and cash equivalents. Time deposits, advance payments in current account and money-market funds may or may not be counted as 'cash', depending the company's treasury policy. In this connection it is notable that the AFM did not find any statement of accounting policy in relation to this item in nearly half of the financial statements it reviewed. It is also notable that the items with the greatest variety in classification are given the least description in the accounting policies.

The choice of the direct or indirect method for preparing the cash flow statement and the classification of interest, tax and dividend is apparent from the cash flow statement itself. It is notable that the AFM found very little other information on the cash flow statement in the description of the accounting policies.

In other words, the accounting policy is in most cases generic in nature (‘boilerplate’) and contains little company-specific information, even though this does not have to be the case. In a couple of financial statements, the AFM for instance found a description of the way in which the companies concerned treat cash flows in foreign currency in the cash flow statement. In one other case, the AFM found a description of the way in which derivative instruments concluded for the purpose of hedging risk were treated in the cash flow statement. This provided valuable information to the users of the financial statements, and such additions add value for users.

3.3 Faithful representation: still under pressure

The AFM notes that the cash flow statement can still be improved in terms of giving a faithful representation. However, the AFM also sees that the cash flow statements in this review have improved in this respect in comparison to six years ago. Our understanding of a faithful representation in this context is that the cash flows presented should concern actual cash flows, and that the cash flows should be presented in the correct categories. Faithful representation also involves correct compliance with mandatory regulations.

Reported earnings are important to investors, however cash flows are at least as important. A company’s potential for continued survival is shaped by its cash flows. The cash flow statement should show a company’s ability to generate cash flows (from operations) and the need to use these cash flows. Since any material breach potentially can lead to an ill-informed investment decision, further improvement is needed here.

IFRS Interpretations Committee: the purpose of the cash flow statement

In 2012, the IFRS Interpretations Committee (IFRS IC) established that two methods are used to classify cash flows in practice:

- in accordance with the nature of the activities in a way that best corresponds to the activities of the company;
- in accordance with the classification of the related or underlying item in the statement of financial position.

The IFRS IC acknowledges that these two methods may contradict each other in some cases. It also acknowledges that the original purpose of IAS 7 was that the operational section of the cash flow statement should as far as possible reflect an income statement on a cash basis. It therefore takes the view that the first method should be applied.

A correctly prepared cash flow statement provides users of the financial statements, including investors, with the following information regarding cash flows:

- The operational cash flow shows the income statement on a cash basis;
- The investment cash flow shows only the changes in the non-current assets on a cash basis;
- The financing cash flow shows only the movements in funding, namely the non-current liabilities and the equity on a cash basis.

AFM: findings
The AFM found the following deviations from the requirements of IAS 7 in the 2012 cash flow statements:

- ten companies count items as cash and cash equivalents that under IAS 7 do not belong to this item. This concerns long-term time deposits and locked bank accounts;
- In the case of fourteen companies, it is not likely that the investments in intangible assets and property, plant and equipment represent cash flows. The cash flow presented reconciles one to one with the change in the related movement schedule. Taking account of investment creditors (among other things), it does not seem likely that this item represents the actual cash flow;
- Five companies presented cash flows in a category other than the category in which they are obliged to present them according to the standard.

From the above, one may conclude that the provisions of IAS 7 have been complied with in the majority of the cash flow statements reviewed. However, we still see significant shortcomings and any material breach of the principle of faithful representation is not acceptable. In view of the importance of the cash flow statement, the AFM therefore calls on all preparers to devote further attention to faithful representation in the cash flow statement and thereby to keep the purpose of the cash flow statement in mind.

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