la SOCIÉTÉ FRANÇAISE
des ANALYSTES FINANCIERS

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Request for Comments, Improving the Statements of Cash Flows (FRC Consultation)

Comments by the French Society of Financial Analysts (SFAF)
Financial Analysis and Accounting Commission

Dear Sir,

The French Society of Financial Analysts, SFAF (Société Française des Analystes Financiers) is pleased to submit its contribution as part of the consultation undertaken by the Financial Reporting Council on Improving the Statements of Cash Flows.

SFAF represents more than 1,500 members in France and is itself a member of the European Federation of Financial Analysts Societies (EFFAS) which comprises 21 member organizations representing more than 16,000 investments professionals. Its Accounting and Financial Analysis Commission intends to represent analysts and fund managers in the debate on accounting standards. Financial analysts are among the principal users of corporate financial statements and therefore wish to express their opinion on the implementation of new or revised accountings standards.

For this reason, our Society, through its Accounting and Financial Analysis Commission, is keen to respond to your consultation on the Request for Comments, Improving the Statements of Cash Flows.

We congratulate the FRC for its discussion paper on cash flow statement: it comes at the right time, i.e. when the IASB is starting its *Primary Financial Statement* Project, which, from the point of view of users, is the key project for IFRS (see SFAF's comment letter dated December 31st 2015 on the IASB agenda[1]). As a reminder, financial analysts have been, for almost half a century, a driving force for the creation of cash flow information: as early as 1967, the European Federation of Financial Analysts Societies, EFFAS (of which SFAF is a member), presented a format of table that could be used for all European groups and included cash flow information.

We have already discussed some aspects of the cash flow statement during the last years, including during the *Financial Statement Presentation* of the IASB, and in some instances, we thus used our work and experience during these previous discussions.

As the subject is key for users, we are sending of copy of this letter to several interested parties (IASB, EFRAG, ESMA, European Commission, ANC, AMF, FASB).

The usefulness of cash flows (Section 1)

While we perfectly understand the argument that assessing liquidity is one of the key goals of the cash flow statement, we believe that most users of financial statements do no look at a cash flow statement primarily to assess liquidity, the financial structure and its change. We strongly believe that most of them actually use cash flow information to complement other financial statement information. In particular, we believe that most users use it to complement the income statement, i.e. performance reporting (e.g. assess the ability of a company to generate cash flows from its operations while being able to invest). In no way it means that the cash flow is less important, but that is partly because most users want, first, to be able to assess performance. With the introduction of fair value changes and non-cash items in the P&L and/or the balance sheet, users need to be able to complement the income statement with the statement of cash flow in order to better assess an issuer performance This is fully consistent with the latest draft of IFRS Conceptual Framework, where the income statement is recognised as the most used/useful statement.

We would like to add that this hierarchy is very consistent with the history of the cash flow statement: it was introduced to complement existing financial statements (i.e. balance sheet and income statement). Changing the main stated goal of the cash flow statement (assessing the liquidity) would mean that we could run the risk of losing the key goal allocated to the cash flow statement when it was created. Finally, we would like to stress that users consider that a cash flow statement is an indispensable component of a complete set of financial statements.

[11] All our comment letters are available at http://www.sfaf.com/think-tank/base-documentaire/ in the category Accounting and Financial Analysis Commission

The classification of cash flows (Section 2)

The discussion paper suggests that operating activities should be defined positively rather than being a default classification after defining financial and investment sections. We understand that from an academic point of view, this could be an improvement. However, as users, we are unaware of any significant real problem for users resulting from this absence of definition. We also stress that this is not an achievable goal as long as the operating profit is not defined properly in the income statement under IFRS.

We completely support the view that unusual items should not be excluded from the operating section, and that, on the contrary, these items should be highlighted by an increased disaggregation and better disclosures to be sure that we fully understand these unusual items.

Regarding the classification of interest and taxes, after listening and debating for years arguments about a classification in operating or financial sections, we have not heard any definitive or completely convincing argument. We understand that is why these items, under IFRS, can be classified in both sections, under the current optional regime. For users, as comparability of the information provided in the main subtotals presented in the financial statements is of utmost importance, we thus favour an approach where both interest and taxes are included in the operating sections, but in a separate sub-sections and with appropriate disclosure (See Additional points, below). Regarding this point, we note this is the approach taken in the USA (FAS 95), and, as far as we know, this has not been seen as a misleading presentation or a source of frustration for users. At the same time, removing these options in IFRS will also achieve greater comparability with US GAAP.

Regarding the classification of cash outflows for property, plant and equipment (PP&E), we recognise that most users tend to calculate a kind of free cash flow, but they prefer to have their own definition and make their own calculations. We are thus not in favour of including cash outflows for PP&E in the operating section. Additionally, and perhaps more importantly, if such a choice were made, we believe that the investment section, in most cases, would be almost empty, and thus made irrelevant. Lastly, we agree that separating replacement and expansion capex is extremely complex, and we are unaware of any reliable methodology to make such a distinction workable and produce reliable figures.

Cash equivalents and the management of liquid resources (Section 3)

We understand the FRC suggests a presentation of cash inflows and outflows rather than cash and cash equivalents inflows and outflows because the cash equivalents are not precisely defined and can be subject to various judgements. We disagree with such a restrictive approach, and we make a parallel with the definition of the net debt concept, widely used by issuers, but also by users, which is, from an academic or standard-setting point of view, not defined. We believe that the improvement of standard setting should not be based on a quest for “pure concepts”, but on concepts that are well understood, and used widely, as long as they are not misleading.

We believe that focusing the cash flow statement only on cash (instead of cash and cash equivalents) will inevitably face similar hurdles as the one encountered with cash equivalents. In a “pure” group we would expect “pure cash” (excluding cash equivalents) to be close to zero almost permanently: change in cash would be almost systematically close to zero. We also understand that most groups actually manage cash and cash equivalents together. We would thus favour a better disclosure of what has been included in the cash equivalents, allowing us to better understand how the judgement has been applied, and perhaps, a list (or examples) of what could be (or not) included in cash equivalents.

Reconciliation of operating activities (Section 4)

An interesting reconciliation has to start from well-defined, and well-known, point so as to be relevant for users. Starting with the net profit meet these criteria, whereas, under current IFRS rules, “operating profit” is not defined precisely, at least today.

We believe that the indirect method (which is, by far, the dominant practice in Europe), when done in an adequate manner, allows users to have a proper reconciliation on the face of the cash flow statement. It is also consistent with the original goal of cash flow statements, i.e. to complement information provided in the balance sheet and income statement.

Direct or indirect method? (Section 5)

The debate about direct or indirect method to present cash from operating activities has been around for many years. We nevertheless feel very close to the Swedish report quoted in paragraph 5.7 stating that no interviewed users indicated that they would prefer a direct method. We understand also that many commonly repeated arguments in favour of the direct method are not so convincing. For instance, the link with cash received from customers and revenues is far from being straightforward: cash received may include some sales tax and some amounts that are reported under IFRS as interest in the income statement. We consider therefore that removing the direct method option would not be a concern for users of financial statements.

We note also that when using a direct method, a reconciliation with an income statement, where operating costs are presented using a per function presentation, is simply impossible. Cash paid to suppliers or cash paid to employees have simply no link with the lines “cost of goods sold”, SG&A, or R&D.

We note that an overwhelming majority of European issuers are using the indirect method. We believe that, for the sake of comparability, it may be reasonable to suppress the option of direct method.

Additional points

Finally, as a suggestion, we would advocate that cash from operating activities should be presented in the following (simplified) format, with no options (as suggested previously):

Net profit

+ depreciation and amortisation

+ provisions / impairments

- capital gains (losses)

+ other non-cash operating expenses (*with significant details*)

+ tax expense

+ interest expense

- interest income

+ other financial expenses (*with significant details*)

= Cash from operations before change in working capital, interest and tax (a)

- change from receivables

- change from inventory

+ change from payables

+ other changes from working capital

= Change in working capital (b)

(a) + (b) = **Cash from operations before interest and tax**

- interest paid (*both on financial debt and operating*)

+ interest received (*both on financial debt and operating*)

- tax paid

= cash from operating activities

We note that this presentation is very consistent with the detailed suggestions made by the Financial Accounting Commission of the European Federation of Financial Analysts Societies (EFFAS), in its comment letter dated 14 April 2009 on IASB *Discussion Paper on Preliminary views on Financial Statement Presentation.* We would like stress that, more recently,both SFAF and EFFAS made some very positive comments on the improvements of disclosures related to cash flows statement in IFRS (*Disclosure initiative. Improvements to IAS 7*), in a letter dated 17 April 2015.

As a more general conclusion, we think the three main practical problems encountered by users with cash flow statements are the existence of options under IFRS to present cash flows, and, more importantly, poor granularity in the operating section, which can be summarized in the infamous disclosure: "net profit + depreciation and amortisation + other non-cash adjustments". Thirdly, we are also expecting enhanced disclosures when a group has a significant level of minority interest. In our opinion, any project on the cash flow statement should thus focus on these points. We also favour a better disaggregation, including a kind of "operating profit" on the face on the income statement.

We thank you for the opportunity given to us to provide our view on such important aspects of financial reporting for users. We really hope that the views of users will drive the work of the FRC and remain available for any further information.

Yours faithfully,

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