point of *view*

December 2013

Cash flow reporting

A call to action

Highlights

- Enhancing cash flow transparency will help users better understand a company's financial health and future prospects.
- The statement of cash flows contains important information and is often the foundation by which users evaluate a company's performance.
- Companies should evaluate the level of transparency provided in the financial statements and Management's Discussion & Analysis regarding their cash flows.
- Companies should also consider whether they sufficiently discuss the primary drivers and material factors giving rise to their cash flows, as well as the predictive value of the historical cash flows.

Enhancing the usefulness of the statement of cash flows

- Enhancing the transparency of a company's cash flow information will help users to better understand the company's relative performance and increase the predictive value of cash flow results. This may benefit the company in the form of greater access to the capital markets and a lower cost of capital.
- The statement of cash flows is regarded by many users of the financial statements in a number of industries as the most important financial statement. It communicates a company's sources and uses of cash and level of investment reflecting the stewardship entrusted in management. It also facilitates an assessment of a company's ability to generate cash. Analyzing the relationship between operating cash flows and earnings over time may lead to useful indicators of a company's long-term financial health and sustainability.
- Accounting standards provide a principles-based framework for presenting sources and uses of cash. We support principles-based standards, although we recognize that their application can be complex. This often leads to diversity in how cash flows are reported and reduces the comparability of financial reporting. Therefore, disclosure of cash flow information is important to enhance the utility of the statement of cash flows.
- Companies can improve the usefulness of their cash flow information—and enhance the understanding of their businesses—in a variety of ways, such as disclosing their cash flow presentation policies and the location of specific transactions within the statement of cash flows. Additional ways consist of providing a more robust and transparent discussion of the primary drivers of cash flow results, including cash inflows and outflows from operating activities.

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Background

The importance of the statement of cash flows

The statement of cash flows contains important information that is often the foundation by which users evaluate performance.

The diversity in how cash flows are reported reduces the comparability of cash flows and results in users needing to make adjustments when performing relative analyses.

Cash flow reporting framework

The accounting guidance provides a principles-based framework for presenting the sources and uses of cash. Cash flows are presented in three distinct categories: operating, investing, and financing under one of two methods—the direct method and the indirect method.

Why the statement is important

The statement of cash flows is regarded by many users of the financial statements in a number of industries as the most important financial statement. When combined with other financial information, the statement of cash flows can be a useful tool to analyze key relationships in the financial statements, evaluate past performance, and predict future performance. Further, because the income statement uses the accrual method, the statement of cash flows is needed to show cash generated and spent.

The statement of cash flows can reveal circumstances in which earnings growth does not correlate with operating cash flow growth. This may alert users to the need to look closely at the drivers of earnings or may be an indicator of other lifecycle considerations for emerging or declining businesses. The statement also facilitates a user's assessment of a company's ability to generate cash from core business activities, which is often a key variable when valuing a business and assessing its ability to repay debt, make capital expenditures, and pay dividends.

Credit rating agencies, investors, and analysts utilize cash flow information when developing valuation models. The transparency of historical cash flow information, including cash inflows and outflows from operating activities, can promote a better understanding of a company's relative performance and enhance the predictive value of its cash flow results.

Differences in cash flow reporting

Inappropriate classification and treatment of non-cash items in the statement of cash flows can result in differences and, when identified, are a frequent cause of restatements. But companies also report cash flows differently based on a reasonable interpretation of the principles-based framework or differences in their facts and circumstances. These factors contribute to reduced comparability of cash flows among companies. Examples of diversity include:

- The acquisition of similar assets is reported as an operating or investing activity depending on whether the assets are considered inventory to be utilized in the generation of revenue (operating) or a productive asset (investing).
- Capitalized interest is reported within investing activities as part of capital expenditures when the expenditure initially occurs and recognized as depreciation expense when the asset is consumed. Operating cash flows of a company that capitalizes significant amounts of interest may need to be adjusted to reflect its true debt service costs.
- There is no prescribed method of presenting cash flows of a discontinued operation. As such, some companies do not report those cash flows in the statement of cash flows; others specifically identify and disclose them in the statement of cash flows in total for each category.
- Dividends that represent a return *on* capital are classified as operating activities while dividends that are a return *of* capital are classified as investing activities.
- Insurance proceeds may be reported as either operating or investing activities depending on whether the insured loss related to an operating activity or a productive asset.

The implications

The reduced comparability among companies due to diversity in how cash flows are reported means that users of the financial statements require greater transparency of cash flow information.

Analysis

Enhancing the usefulness of cash flow information

Companies should consider whether their financial statements provide enough disclosure of how they report cash flows and the primary drivers and material factors giving rise to cash flow results.

What companies can do

There are several actions companies can consider to increase the usefulness, transparency, and predictive value of a company's cash flow information.

- Enhance liquidity disclosures by analyzing meaningful cash flow metrics. Provide guidance to help communicate management's view of future cash flow prospects.
- Enhance the footnote disclosure of the basis for presenting items in the cash flow statement, identifying where and how significant and unusual transactions are reflected in the statement.
- Enhance disclosure of the drivers of cash inflows and outflows from period to period, including describing in Management's Discussion and Analysis the primary drivers of cash flows such that a user can evaluate the predictive value of historical cash flows. For example, what caused inventory to increase and what are management's future expectations? Understanding the reasons for changes in line items comprising cash flows from operations could help users evaluate whether earnings growth will correlate with future cash growth based on past performance.
- Enhance the presentation and discussion of the drivers of cash flows on an interim basis. This could include providing expanded cash flows from operating activities similar to annual presentations—rather than the abbreviated presentation permitted under SEC regulations.
- Differentiate between operating cash flows of continuing businesses and discontinued businesses.
- Recast historical information after a business is discontinued. If a company elects to disclose cash flows from a discontinued operation, comparative periods are only required to be retrospectively adjusted when those periods are presented. However, providing information on the effect of the change on all periods, including interim periods at the time of the change could reduce the need for users of the financial statements to make their own assumptions about the impact of the change on historical periods.
- Benchmark the company's cash flow reporting against a peer group to identify similarities and differences in cash flow presentation. Disclosing the company's policy for classification and highlighting that other companies may present similar information differently can alert users to where adjustments may be necessary when comparing relative performance.

Evaluate reporting processes

Companies should also critically evaluate their reporting processes. This should entail assessing whether they have the right processes and internal controls in place to identify unusual, non-recurring, or significant non-cash items occurring during a reporting period that require evaluation to determine appropriate classification and potential disclosure. The indirect method identifies changes in the balance sheet between periods. As a result, infrequently occurring non-cash items may not be identified and appropriately reflected within the statement of cash flows.

In summary

Companies should consider whether their financial statements provide enough disclosure and discussion of the primary drivers and material factors giving rise to their cash flow results. Enhanced disclosure may help users of the financial statements better understand differences in relative cash flow performance and the predictive value of a company's cash flows.

Companies that increase the transparency of their cash flows thus may improve a user's understanding of their business. This in turn may benefit companies in the form of greater access to the capital markets and a lower cost of capital.

Questions and answers

Q: What is the difference between the direct and indirect methods of reporting cash flows?

A: Under the direct method companies report major classes of gross operating cash receipts and payments such as cash collected from customers, cash paid to suppliers, and interest paid.

Under the indirect method major classes of operating cash flows are derived by adjusting revenue and expense amounts for the changes during the period in related asset and liability accounts. Net income is adjusted for noncash earnings and the change in operating assets and liabilities to arrive indirectly at operating cash flows.

Q: What are some of the cash flow metrics used to compare business performance among companies?

A: Common cash flow measures that have been developed to evaluate the relative performance of a company include free cash flow, cash flow from operations, funds from operations, and discretionary cash flow, on an as reported or adjusted basis, among others.

Q: How have cash flow reporting methods evolved from a standard setting perspective?

A: Since the Financial Accounting Standards Board issued FAS 95, *Statement of Cash Flows*, in 1987, there have not been any significant revisions to cash flow reporting models.

The FASB began its Financial Statement Presentation Project ("Project") in 2001 with a core objective of presenting financial information so that it would be useful in predicting a company's future cash flows. At that time, the FASB reconsidered whether companies should be required to use the direct method of reporting operating cash flows. Feedback from users of the financial statements generally supported the use of the direct method, indicating the resulting information was more transparent and led to better decision making. Preparers generally did not support mandating use of the direct method, citing the cost and excessive level of disaggregation. The board tabled the Project in 2011 until there was sufficient capacity to review its tentative decisions. It has not indicated when the project will resume.

Recently, the FASB issued an exposure draft that would mandate disclosure of cash flows arising from discontinued operations. In November 2013, the FASB completed its review and evaluation of public comments on the exposure draft and voted to issue a standard that is expected in early 2014.

Companies will need to disclose operating and investing cash flows for components of a business that meet the revised definition of a discontinued operation. Financing cash flows of discontinued operations will not be required to be disclosed.

Contact Information

To have a deeper discussion about our point of view on cash flows, please contact:

David Evans
Partner
Phone: 973-236-4004
Email: david.m.evans@us.pwc.com

Beth Paul
US Strategic Thought Leader, Accounting Services Group
Phone: 973-236-7270
Email: elizabeth.paul@us.pwc.com

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