Accounting Technical Services

Hot Topic

What does good look like?
– Improving cash flow statements and liquidity disclosures

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Cash flow statements and liquidity disclosures

Introduction

This Hot Topic sets out the key findings identified by the Financial Reporting Council (“FRC”) in its [Thematic Review: Cash flow and liquidity disclosures] by providing a checklist of examples of better disclosure that were identified from the companies included within the Review.

The checklist therefore sets out the key ways in which companies can look to improve the financial reporting disclosures within their:

- cash flow statements;
- strategic reports;
- going concern statements,
- viability statements; and
- liquidity disclosures.

The checklist does not set out all the disclosure requirements required for compliance by applicable IFRSs, such as IAS 1 *Presentation of Financial Statements*, IAS 7 *Statement of Cash Flows* and IFRS 7 *Financial Instruments Disclosures*, but instead supplements those IFRS disclosure requirements with examples of what better disclosures look like.

The checklist also sets out the common issues and areas of non-compliance that companies should look to avoid within their reporting.

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Cash flow statements - IAS 7 *Statement of Cash Flows*

To improve disclosures in the cash flow statement, include:

Composition of cash and cash equivalents

- ✓ An accounting policy detailing what constitutes cash and cash equivalents.
- ✓ Analysis of the components of cash and cash equivalents.
- ✓ A description of the terms of deposits, such as maturity and interest rates.
- ✓ Whether overdrafts are included within cash and cash equivalents and, if so, the terms of such arrangements.
- ✓ Disclosure of the amount of restricted cash and the nature of the restrictions.

Cash flows from operating activities

- ✓ A reconciliation to explain the cash flow impact of working capital movements, where this was not apparent from the statement of financial position.
- ✓ A logical ordering of the items presented, for example, grouping similar items together such as working capital movements and non-cash items.
- ✓ References to relevant notes.

Cash flows from investing activities

- ✓ References to notes which agree to the amounts presented in the cash flow statement; and
- ✓ A reconciliation between the cash flows in the cash flow statement and notes where the reason for the difference was not apparent.

Acquisition and disposal of subsidiaries

- ✓ References to notes which agree to the amounts presented in the cash flow statement.
- ✓ A breakdown of the cash flows resulting from the acquisition or disposal of subsidiaries and other businesses.

Deferred or contingent consideration

- ✓ An explanation of the accounting policy applied for the cash flow statement presentation of deferred or contingent consideration.
- ✓ A breakdown of the amounts shown within each section of the cash flow statement.

Disclosure of accounting policies

- ✓ A description of where contingent consideration is presented within the cash flow statement.
- ✓ An explanation of where cash flows from supplier financing arrangements are presented within the cash flow statement.
- ✓ An explanation of where cash flows from leases are presented.

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Strategic reports

To improve disclosures in the strategic report, include:

Operating and financial review

- ✓ Summary cash flow statement information, including year-end cash and net debt positions, supported by an explanation of the cash flows by operating, investing and financing activities.
- ✓ Explanations of movements in cash, net debt or debt maturity profiles.
- ✓ Descriptions of available liquid resources, including composition of cash and cash equivalents and undrawn borrowing facilities.
- ✓ Details of debt and borrowing facilities including financial covenants.
- ✓ Disclosure of other relevant obligations such as off-balance sheet arrangements, supply chain financing, pension commitments and contingent liabilities.
- ✓ Narrative explanations of cash and liquidity based APMs such as free cash flow, cash conversion, net debt and leverage.
- ✓ Explanations of terms such as 'available liquidity' to allow users to understand how it relates to amounts presented in the financial statements.
- ✓ Explanations that clearly distinguish between discussions of the company's liquidity position at the balance sheet date and the date the financial statements were signed.

Use of APMS and KPIs

- ✓ Explanations of why variants of certain measures were used, for example, where one measure of leverage is used by management and another measure is used for covenant testing.
- ✓ A comprehensive section on APM disclosures detailing definitions, explanations and reconciliations where multiple APMs are used.
- ✓ Disclosure of the closest equivalent statutory measure for each APM presented.
- ✓ APM disclosures that:
  - Have clear and accurate labelling;
  - Have an explanation of their relevance and use;
  - Are reconciled to the closest IFRS measure; and
  - Are not given more prominence than the equivalent IFRS measures.

Principal risks and uncertainties – Liquidity or funding risks

- ✓ Entity-specific risks and changes to those risks both during the year and anticipated to arise in the future.
- ✓ A description of mitigating factors and actions taken.
- ✓ Links to strategy, business model and KPIs.

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Going concern and viability statements

To improve disclosures in the going concern and viability statements* include:

Going concern statements

- ✓ Clear explanations of any material uncertainties that may cast doubt on the company's going concern status.
- ✓ Explanations of the different going concern scenarios that had been considered, such as the impact of Covid-19.
- ✓ An indication of which inputs were subjected to stress tests and explanations of how these stress tests affected the going concern conclusions.
- ✓ Explanations of whether the company would need to make structural changes in order to continue to operate as a going concern.
- ✓ Explanations of the company's exposure to vulnerable sectors, countries and key suppliers.
- ✓ Descriptions of the assumptions which were considered before the impact of Covid-19 were known.
- ✓ Outputs of reverse stress tests and commented on the likelihood of such scenarios.
- ✓ Descriptions of the governance process taken by the board to challenge the assessment made.

Viability statements

- ✓ Identification of areas which are particularly subject to uncertainty and how that uncertainty may be mitigated.
- ✓ Explanations of the viability scenarios that had been prepared, including a description of key assumptions within each scenario and how they impacted the viability conclusion.
- ✓ An indication of which inputs had been subject to stress testing and reverse stress testing and explanation of how this impacted the viability assessment.
- ✓ Explanations of the impact of post balance sheet events such as the arrangement of new lending facilities, extension of existing facilities and renegotiation or waiver of bank covenants.
- ✓ Links to relevant information included in other areas of the annual report.

***FRC area of consideration:* Given the current uncertain environment, the FRC has announced that it is even more important that the viability statement sets out clearly the company's specific circumstances, and the degree of uncertainty about the future. In particular, companies should draw attention to any qualifications or assumptions made in determining the company's viability.**

* *A viability statement is required to be provided by all companies with a Premium Listing of equity shares in the UK

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Liquidity risk disclosures - IFRS 7 *Financial Instruments Disclosures*

To improve liquidity risk disclosures in accordance with IFRS 7 *Financial Instruments Disclosures* (“IFRS 7”), include:

Qualitative disclosures

- ✓ Entity-specific policies on managing liquidity risk.
- ✓ Details of liquid resources and uncommitted facilities.
- ✓ References to liquidity information contained in other notes.
- ✓ Information about any changes to liquidity risk management.

Maturity analysis

- ✓ Clear explanations of what the maturity analysis represented.
- ✓ Information that is presented in a way which could be easily compared to items in the statement of financial position (for example, showing the carrying value next to the total of undiscounted contractual cash flows).
- ✓ All relevant liabilities, including lease liabilities, presented together for easy analysis.
- ✓ Sufficient granularity in the time bands chosen.

FRC area of consideration: **While the appropriate level of disaggregation of time bands may differ between companies, companies should consider whether a greater degree of disaggregation than reported previously is required in the current circumstances.**

Companies should also consider if it is clearer to present liquidity information together in one location rather than in separate maturity tables.

Seasonality

- ✓ Disclosure of the maximum drawdown of revolving credit facilities during the year.
- ✓ Explanations of the impact of seasonality on liquidity and working capital in comparison to seasonality in the business operations.
- ✓ Use of metrics which considered average exposures in the reporting period (such as average daily net cash) in addition to the position at the reporting date.

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Liquidity risk disclosures - IFRS 7 *Financial Instruments Disclosures* (continued)

To improve liquidity risk disclosures in accordance with IFRS 7, include:

Compliance with banking covenants

- ✓ How calculated covenant ratios compare with the requirements of lending arrangements.
- ✓ The available headroom;
- ✓ Whether the adoption of IFRS 16 *Leases* had any impact on covenants.
- ✓ Any waivers agreed with debt providers.
- ✓ Any changes post year-end as a result of further measures taken (for example, equity raise).
- ✓ The impact on covenants of new borrowing facilities and government support.
- ✓ How often covenants are tested.
- ✓ How covenant levels will change over time.
- ✓ Any restrictions on the company such as over shareholder distributions or acquisitions.

Working capital and supplier financing arrangements

- ✓ A description of the supplier financing arrangements used including the purpose of the arrangement.
- ✓ How amounts relating to the arrangement are presented in the balance sheet and cash flow statement.
- ✓ Details of interest or fees payable.
- ✓ The impact on the timing of the company's cash flows.
- ✓ How liquidity risk is managed in relation to the risk of losing access to the facility.

***FRC area of focus:* Where companies are using material supplier financing arrangements, disclosure is expected of:**

- **the amount of the facility and usage;**
- **the accounting policy applied, including the basis on which the company recognised the liability to suppliers;**
- **whether the liability is included within the determination of key performance indicators such as net debt;**
- **the cash flows generated by such arrangements; and**
- **the impact on liquidity risk which could arise from losing access to the facility, for example, acceleration of payments to suppliers leading to demands on cash and working capital.**

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Cash flow statements - Common issues and non-compliance

The FRC's Review also identified a number of significant issues and areas of non-compliance amongst cash flow statements that were common throughout the companies included within the Review. Set out below are those common issues and areas of non-compliance with IAS 7, which should be used by companies as a checklist to avoid. The errors typically related to: investing activities, the definition of cash and cash equivalents, the reconciliation of profit to net cash flows from operating activities, the acquisition or disposal of subsidiaries, incorrect classification of cash flows and omission of disclosures for compliance.

General

- **The reconciliation of profit to net cash flows** - Expenses from the income statement incorrectly deducted, rather than added back, in the reconciliation.
- **Non-cash items** - Non-cash movements relating to the unwind of a discount and assets purchased under finance leases incorrectly included as cash flows.
- **Treatment of interests and dividends** - Accounting policies for the presentation of interest and dividends not compliant with IAS 7 nor applied consistently.

Cash flows from operating activities

- Changes in cash flows from working capital inconsistent with movements in the statement of financial position.
- Material unexplained variances identified in impairment and depreciation charges between the cash flow statement reconciliation and the notes to the accounts.
- Post-acquisition and restructuring cost cash flows included within investing activities rather than operating activities.
- Acquisition-related expenses recognised in the income statement incorrectly classified as investing activities rather than operating activities.
- Restructuring cash outflow incorrectly classified as investing activities rather than operating activities.

Cash flows from financing activities

- Settlements of liabilities shown as a cash flow in the disclosure of changes in liabilities arising from financing activities which are excluded in the cash flow statement.
- Settlements of financing liabilities in the cash flow statement which are inconsistent with movements in the statement of financial position and notes.
- Non-cash amounts, such as assets purchased under finance leases and non-cash finance charges, incorrectly presented as cash flows.
- Cash flows on loans payable incorrectly netted and classified as operating activities rather than financing activities.

Cash flows from investing activities

- Material unexplained differences identified in additions to property, plant and equipment between the cash flow statement and the property, plant and equipment notes.
- Settlements of provisions and other liabilities incorrectly being presented as investing cash flows.
- Payments for the purchase of businesses incorrectly classified as operating activities rather than investing activities.
- Cash flows relating to joint venture funding incorrectly classified as financing rather than investing activities.
- Advances to joint ventures were presented as operating cash flows rather than investing activities.

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