Ms Michelle Sansom
IFRS Foundation
30 Cannon Street
London
EC4M 6XH

18 March 2015

Dear Michelle,

This letter sets out the comments of the UK Financial Reporting Council (FRC) on the Exposure Draft (ED) '*Disclosure Initiative (Proposed amendments to IAS 7)*'.

We broadly support the IASB's proposals for the introduction of disclosures around debt and liquidity in response to requests from investors and others; research over an extended period of time has provided a strong body of evidence that demonstrates demand from UK and international investors for disclosures that provide more information about the net debt, liquidity, capital structure and cash management of an entity.

With this in mind, our preference would be for the IASB to introduce a requirement for entities reporting under IFRS to disclose a net debt reconciliation. In our view, the reconciliation proposed in the ED provides a good starting point. However, we believe that it would be helpful to clarify in the standard itself that entities may build upon the disclosure requirements proposed in the ED to provide a net debt reconciliation, rather than this permission being stated in the basis for conclusions only.

Our main comments on the ED are summarised below with our detailed responses to the consultation questions included in Appendix 1 to this letter. A summary of the FRC's research on investors' use of net debt reconciliations is included in Appendix 2.

a) Flexibility in reporting debt and net debt

We acknowledge the difficulties associated with developing a definition of 'debt' or 'net debt'. In the absence of a definition, the disclosure requirements should make it clear that entities have the option to provide a single note which includes components of net debt that are not captured by the disclosure proposed in paragraph 44A. We believe this flexibility will result in more meaningful and useful disclosures for investors.

b) Objectives for the reconciliation

We believe that including in the standard a clear objective for the disclosure would assist each entity with identifying the relevant components that it is appropriate to include in the reconciliation in its particular circumstances.

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c) Restrictions on the use of cash and cash equivalents

We agree that disclosure of restrictions on the use of cash and cash equivalents may provide relevant information to investors. However, we believe that the scope and objective of the requirement in paragraph 50A is unclear and it may be interpreted too broadly. In particular, the IASB should clarify how the requirement to disclose 'restrictions' is distinct from the existing requirements in paragraphs 48 and 49 of IAS 7.

d) IFRS Taxonomy

In our view, including proposed amendments to the IFRS taxonomy as part of the IASB's consultations on proposed amendments to the standards will result in an inefficient process. There is also a risk that proposed amendments to the IFRS taxonomy unintentionally interpret proposed amendments to the standards or detract from the aim of developing principles-based standards.

If you would like to discuss these comments, please contact me or Rosalind Szentpéteri on 020 7492 2474.

Yours sincerely

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Appendix 1: responses to consultation questions

Question 1 – Disclosure Initiative Amendments
This Exposure Draft of proposed amendments to IAS 7 forms part of the Disclosure Initiative. Its objectives are to improve: a) information provided to users of financial statements about an entity's financing activities, excluding equity items; b) disclosures that help users of financial statements to understand the liquidity of an entity. Do you agree with the proposed amendments (see paragraphs 44A and 50A)? Do you have any concerns about, or alternative suggestions for, any of the proposed amendments?

Yes, insofar as they go, although we consider them incomplete. While we broadly agree with the proposed amendments, we would have preferred a requirement to disclose a net debt reconciliation because this would more fully meet investor demands. In the absence of such a requirement, the main body of the standard should make it clear that the required disclosure may be incorporated into a net debt reconciliation.

<u>Flexibility in reporting debt and net debt</u>

Other components of gross debt

We believe it is important that the requirements in the standard provide entities with sufficient flexibility to report the information that they consider to be relevant for their investors, reflecting their debt and cash management process. Similar flexibility is given in paragraph 135 of IAS 1 *Presentation of Financial Statements* for entities to define 'capital' themselves, in a way that is appropriate for their business. In our view, a prescriptive method of identifying the items to include in the reconciliation is unnecessary; investors' main concern is that the items and movements included in the reconciliation are clearly identified and can be reconciled to the statement of financial position and the statement of cash flows.

The disclosures in the ED provide a good starting point but the requirements proposed in paragraph 44A may provide an incomplete picture of an entity's (gross) debt position because the requirements, as drafted, may not capture some items that are generally considered to be part of debt.

For example, paragraph 33 of IAS 7 states that there is 'no consensus' on how interest paid or received should be classified within the statement of cash flows, and that these cash flows may be presented within operating, investing or financing activities. When interest paid or received is classified within either operating or investing activities, it would not meet the criteria for inclusion in the proposed debt reconciliation that are set out in the ED. Similarly, any related accrued interest balances that are shown separately in the statement of financial

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position would not be captured as items to be reconciled. This is illustrated in example E in the ED.

Our recommendation that entities be permitted to determine the components of their debt will partly address this. In addition, we suggest that the word ‘financing’ is deleted from paragraph 44A(b)(i). This will ensure that the requirement captures all cash flow movements related to the items in the reconciliation.

Other components of net debt

Paragraph BC6 states that ‘investors could calculate a net debt position from’ the information in the proposed disclosure requirements. Paragraph BC8 defines a ‘net basis’ as ‘the amounts in the statement of financial position for which cash flows have been, or would be, classified as financing activities, excluding equity items, less cash and cash equivalent balances’.

In many cases, simply deducting cash and cash equivalents from gross debt would not enable investors to calculate the net debt position because the entity may also hold liquid resources that could be used to settle debt, and are part of the entity’s debt and cash management process. We note that this issue was highlighted by the Global Preparers Forum, however this concern is not reflected in the proposed disclosure requirements.

The ED acknowledges that ‘a ‘gross reconciliation’ could be perceived as reducing information and limit management’s ability to explain its financial and risk management strategies’. While paragraph BC8 states that ‘the requirement for the disclosure should not prohibit disclosures from being provided on a net basis’, we believe this should be stated prominently in the standard itself.

<u>Objectives for the reconciliation</u>

We suggest that the standard includes clear objectives for the reconciliation, to assist entities with making judgements when identifying the relevant components of debt in their particular circumstances. In our view, the objectives of the (gross) debt reconciliation should be to:

- identify the items included in borrowings;
- reconcile movements in items in the statement of financial position that are borrowings to movements in the statement of cash flows; and
- identify non-cash flow movements in borrowings.

<u>Restrictions on the use of cash and cash equivalents</u>

The distinction between the existing disclosure requirements in paragraphs 48 and 49 of IAS 7 (which require disclosure of ‘the amount of cash and cash equivalent balances held by the entity that are not available for use by the group’) and the disclosure requirements proposed in paragraph 50A needs to be made clearer, in particular the difference between the terms ‘not available’ and ‘restricted’.

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The existing disclosure requirements capture cash and cash equivalents that are required to be held for regulatory purposes, and cash and cash equivalents that are subject to exchange controls, because they are 'not available'.

Is the IASB's intention is to distinguish 'not available' as an absolute from 'restrictions' as a matter of degree, i.e. is 'restrictions' intended to refer to legal restrictions that would have a material economic impact on the entity if it were to use the cash and cash equivalents, but do not prevent their use (so that the cash is still technically 'available')? It is unclear from the current drafting of this disclosure requirement under what circumstances (other than when there are tax liabilities that would arise on repatriation of foreign cash and cash equivalents, the example provided in paragraph 50A) cash or cash equivalents would be 'available' but considered to be 'restricted'.

We are concerned that the scope of the proposed disclosure requirement may be interpreted too broadly; there are varying degrees of restriction that may 'affect the decisions of an entity to use cash and cash equivalent balances', including internal restrictions such as working capital requirements or planned investments. A requirement to assess and disclose such internal restrictions would be onerous for preparers, particularly in the case of large international groups, and impractical to enforce.

If the primary purpose of this disclosure is to capture restrictions relating to tax liabilities that would arise on repatriation, we believe it would be more appropriate for this disclosure requirement to be included in IAS 12 *Income Taxes*.

<u>Separate disclosure of different types of reconciling movements</u>

If different types of movements may be disclosed together as a single amount this could obscure useful information. However, it is not clear from the drafting of paragraph 44A(b) whether different types of movements should be disclosed as separate amounts in the proposed reconciliation, when material.

For example, it would be helpful to show separately the effect of changes in foreign exchange rates because this information is not usually disclosed elsewhere in the financial statements and may be obscured if disclosed with other types of movements as a single amount. Similarly, paragraph 44A(b)(i) does not state whether the different types of cash flows presented as financing activities (as set out in paragraph 17 of IAS 1) should be disclosed separately or as a single amount showing only the net movement in cash flows from financing activities. We note that IAS 7 currently allows the net presentation of cash flows only in the specific circumstances set out in paragraphs 22 to 24, and that the cash flows required to be included in the proposed reconciliation would not always meet these criteria.

Investors participating in the research of the FRC's Financial Reporting Lab indicated that separate disclosure of different types of reconciling movements is informative. In particular, investors noted the importance of separate disclosure of finance lease additions, foreign exchange movements, fair value movements, acquired debt, disposals, indexation movements and interest accruals. We suggest that the IASB amends the language in paragraph 44A(b) to clarify that different types of movements should be shown as separate

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line items in the reconciliation, when material, and expands example E to include the items in paragraph 44A(b).

Question 2 – Transition Provisions
Do you agree with the proposed transition provisions for the amendments to IAS 7 as described in this Exposure Draft (see paragraph 59)? If not, why and what alternative do you propose?

Yes. We agree with the proposal that the amendments should be applied prospectively from their effective date, with early application permitted. The proposed amendments do not affect classification, measurement or recognition so there is no need for retrospective application. We agree that no transition provisions are necessary.

Question 3 – IFRS Taxonomy
Do the proposed IFRS Taxonomy changes appropriately reflect the disclosures that are set out in the proposed amendments to IAS 7 and the accompanying illustrative example? In particular: a) are the amendments reflected at a sufficient level of detail? b) should any line items or members be added or removed? c) do the proposed labels of elements faithfully represent their meaning? d) Do you agree that the proposed list of elements to be added to the IFRS Taxonomy should be limited to information required by the proposed amendments to IAS 7 or presented in the illustrative examples in IAS 7?

There is a risk that proposed changes to the IFRS taxonomy unintentionally interpret the standards or imply a greater degree of prescription than is intended, due to its rigid structure and focus on quantitative disclosures. This may detract from the aim of developing principles-based standards that focus on the objectives of disclosure.

For example, paragraph 10 of the proposed changes to the IFRS taxonomy in this ED implies that an amount should be disclosed for tax liabilities that would arise on the repatriation of foreign cash and cash equivalent balances, whereas the proposed wording for paragraph 50A of the standard itself seems to imply that qualitative disclosure would be sufficient.

It is also difficult to assess whether the proposed changes to the IFRS taxonomy are appropriate when reviewing them in isolation. It would be easier to determine whether these

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proposed changes to the IFRS taxonomy contain a sufficient or excessive level of detail if they were consulted on together with changes arising from amendments to other standards, enabling the consistency of the various updates to be considered.

Question 4 – IFRS Taxonomy due process
As referenced in paragraph BC20, the IASB is holding a trial of a proposal to change the IFRS Taxonomy due process. Although not constituting a formal public consultation of the IFRS Taxonomy due process, views are sought on the following: a) do you agree with the publication of the proposed IFRS Taxonomy Update at the same time that an Exposure Draft is issued? b) do you find the form and content of the proposed IFRS Taxonomy Update useful? If not, why and what alternative or changes do you propose?

In our view, it would be more helpful for the proposed changes to the IFRS taxonomy to be consulted on in an agreed amendment cycle, rather than simultaneously to proposed changes to the standards. Based on our experience of developing taxonomies this would create a more stable platform and enable a more holistic and efficient process for reviewing proposed changes to the IFRS taxonomy.

We also note that updating the IFRS taxonomy at the same time as amending the standards creates challenges for software producers in terms of keeping their products up to date. A single 'batch' of updates prior to the effective dates of the changes to the relevant standards would be more practical to implement.

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Appendix 2: FRC research on investor information needs

Since adopting IFRS many UK companies, including the vast majority of FTSE 100 companies, disclose a net debt reconciliation on a voluntary basis because investors find this information useful. The development of this practice was partially driven by the former UK GAAP reporting requirement for disclosure of a net debt reconciliation. However, we note that the majority of investors using this information operate internationally; non-UK based investors hold over 50 per cent of shares in UK listed companies by value, based on the latest official figures available from the Office for National Statistics.[1] The vast majority of UK based investors also operate internationally, holding a significant proportion of their portfolios in overseas entities.

In 2012, the FRC's Financial Reporting Lab carried out a research project on net debt reconciliations.[2] Net debt is a key measure which is referred to repeatedly in annual reports. Our research has shown that a large majority of investors use a net debt reconciliation in their analysis of a company. Investors typically attempt to reconstruct a net debt reconciliation when an entity does not disclose one, however they comment that almost always there is a component missing that cannot be seen from the notes.

Many investors accept that entities use their own definition of net debt to prepare the reconciliation, provided that there is sufficient disclosure to enable them to understand what is included and excluded and how the amounts reconcile to the financial statements and to adjust these amounts appropriately to fit their own analytical models. Given that investors make such adjustments to fit their own models, it appears that little benefit (in terms of comparability, ease of use, or the usefulness of the information) will be achieved by entities using prescriptive criteria to determine the items to include in debt.

Some investors state that allowing entities the flexibility to report net debt in line with how it is managed internally results in more meaningful and useful disclosures, and that they value information about how management view and manage their overall debt and cash position. We do, however, note that several investors that participated in the Lab's research did favour a standard definition of 'net debt'.

Further research[3] by the FRC in 2012 highlighted that credit analysts and bond fund managers investing in UK and international markets believe that there is insufficient information in the financial statements on net debt and liquidity. The requirement in former UK GAAP for disclosure of a net debt reconciliation was also developed based on outreach and consultation with investors and other stakeholders.

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[1] The latest Statistical Bulletin published by the Office for National Statistics on the ownership of UK quoted shares was published in 2012 and can be accessed at http://www.ons.gov.uk/ons/dcp171778_327674.pdf

[2] The Financial Reporting Lab's report '*Net Debt Reconciliations'* can be accessed at https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/FRC-Lab-project-report-Net-Debt-Reconciliations.pdf.

[3] The FRC's research paper '*How credit analysts view and use financial statements*' can be accessed at https://www.frc.org.uk/Our-Work/Publications/ASB/How-credit-analysts-view-and-use-the-financial-sta.pdf

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