Lab project report: Operating and investing cash flows

November 2012

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Contents

Project background

When talking to investors and companies about the areas that they would like the Financial Reporting Lab (the Lab) to cover, debt and cash flow reporting came high on the list of priorities. Reflecting this, the Lab included four related areas of disclosure in its initial list of topics:

- Net debt reconciliations
- Cash flow statements
- Debt terms and economic obligations
- Debt maturity schedules.

The Lab involved the same group of company participants and members of the investment community in discussions across all four topics. The project focused on existing reporting practices and aims to encourage more companies to consider adopting the practices highlighted as helping companies to meet the analytical needs of investors.

This report features the second topic, and is being published together with a report on the third and fourth topics, *Lab project report: Debt terms and maturity tables*.

Lab project report: Net debt reconciliations was published in September 2012.

References made in this report to views of 'companies' and 'investors' refer to the individuals from companies and investment community organisations that participated in this project. The term 'investors' is used as shorthand to refer to the investment community participants in this project, which include a broad range of individuals in their capacity as investors or their role in analyst organisations that work in the interest of investors.

Unsurprisingly, investors have different views on certain characteristics of reporting discussed. Where possible, the views have been distinguished by type of investor and their use of reported information, as well as the importance of particular disclosure in light of general economic, market or company circumstances.

While there may be messages in this report for all involved in corporate reporting, the findings were discussed mainly in the context of companies outside of the financial services sector.

Information that investors do not use could be considered to be clutter. However, this project on operating and investing cash flows has shown the need for more disclosure in this specific area.

What is the Lab?

The Financial Reporting Lab has been set up by the Financial Reporting Council to improve the effectiveness of corporate reporting in the UK.

The Lab provides a safe environment for listed companies and investors to explore innovative reporting solutions that better meet their needs.

Lab project reports do not form new reporting requirements. Instead, they summarise observations on practices that investors find useful to their analysis and encourage companies to consider adopting the practices if appropriate in the context of their own reporting.

Find out more about the Lab including information about other projects at: http://www.frc.org.uk/Our-Work/Codes-Standards/Financial-Reporting-Lab.aspx

Do you have suggestions to share?

The Lab encourages readers of this report to provide comments on its content and presentation. As far as possible, comments will be taken into account in shaping future projects. To provide comments, please send us an email at: FinancialReportingLab@frc.org.uk

Summary of project process and observations

Summary of project process

Five companies in the UK that recognise the importance of good reporting offered to participate in this project to have the Lab facilitate investor feedback on the usefulness of their existing published disclosure on debt and cash flows.

The five companies are:

- BT Group
- National Grid
- Royal Dutch Shell
- Vodafone
- Xchanging

The overall objective of this project was to explore various voluntary practices and to identify those that investors found useful, indicating why this is the case and how information is used.

The Lab worked with these companies to:

- develop a list of questions to be discussed with investors; and
- identify illustrative excerpts from their accounts to be used during the meetings with investors.

Comments and thoughts on these were gathered by the Lab in a series of mainly face-to-face discussions with members of the investment community, focusing on their information needs for analysis. Over 30 individuals from 16 investment organisations provided input, covering a wide spectrum of those using reported information.

For further details on the process, see the section of this report on 'Project methodology'.

"We take engagement with shareholders, analysts and the wider investment community very seriously. Our approach is to be open and transparent, and to encourage candid dialogue."

Ken Lever, Xchanging

Summary of project observations

The generation of cash flows and how they are reported is always important to equity valuation. When there are concerns over cash flow generation, gaining clarity as to cash generated from operations and invested in the business can be critical to explaining trends and answering those concerns.

This project addressed information presented in the cash flow statement. There were few distinctions between the needs of those investors focused on equities versus fixed income or credit analysis.

While there were some differences in the views of individual investors, the main conclusions drawn from their comments were suggestions that companies should:

- report the indirect method of reconciling a profit or loss amount to operating cash flows as part of the main cash flow statement, rather than in a note. This is particularly helpful to investors when viewing reports on electronic media.
- start the cash flow statement with operating income or loss (if this is permitted by the local regulatory authority). If starting with a profit or loss figure further down the income statement such as net profit or loss, then reconcile first to a sub-total for operating income or loss.
- list separately adjustments between the starting profit or loss figure and operating cash flows such as: individual components of working capital changes, pensions, provisions, and any other items that from an industry or company standpoint are significant drivers of the difference. Investors often cannot calculate the separate amounts for these, if the company has, for example, foreign currency transaction or translation adjustments, acquisitions, disposals, or hedge accounting adjustments that significantly affect the value of the related balance sheet line items.
- list separately on the cash flow statement the cash amounts paid for income taxes and interest, and interest income received.

For companies that start their cash flow statement from a profit or loss amount that includes tax or interest, this means showing in the statement the income or expense amounts being removed, and the cash amounts replacing them.

- regarding investing cash flows, separately disclose capital expenditure (capex) for tangible and intangible components, indicating through disclosure the company's view on the portion attributable to maintenance and growth where this is significant to the business.
- make clear through disclosure significant non-cash amounts such as additions to finance lease obligations, or investments that are contributed to fund pension obligations.
- describe each item on the cash flow statement so that its relationship to any corresponding item on the balance sheet or in the income statement can be understood. For example, use the same term to describe the item as is used on the balance sheet or income statement, and make clear whether the item on the cash flow statement represents cash, income or expense, or a difference between the two.
- show metrics that are set as strategic targets, how they are calculated and whether targets are achieved.
- regularly disclose the cash amounts related to any profit or loss amounts that are highlighted as being 'unusual', 'exceptional' or referred to by a similar term.

The project did not address the direct method of cash flows. Nor did it specifically address the classification of items between operating, investing and financing. However, many investors commented that they routinely reclassify amounts of tax and interest from investing and financing cash flows into operating cash flows. This suggests at a minimum it is helpful to investors when these are displayed clearly in the statement so that reclassification adjustments can be made.

The section 'Example disclosures' provides illustrations of many of the reporting practices noted by investors, taken from the published annual reports of the companies participating in this project.

For further details of the observations made by investors see the section 'Investor observations'.

Next steps

Companies are encouraged to consider whether the suggested approaches described are relevant to their own circumstances, and if so, to enhance their reporting to meet investor needs more fully.

The Lab considers there to be room for further dialogue and development of enhanced disclosure in this area. Should companies want to build on the existing practices highlighted and explore potential new approaches, the Lab would be pleased to discuss this topic further.

Lab comment

While investors often speak of forecasting cash flows, this is only sometimes done on the basis of actual cash flows. Typically, the focus is on earnings and elements of the income statement used as proxies for cash flows. As a result, investors have a significant interest in understanding, and in having companies explain, the conversion of earnings to cash.

The cash flow statement, and more specifically the reconciliation of a profit or loss amount to operating cash flows, shows how profit or loss relates to cash flows. This Lab report focuses on the clarity with which such information is presented to best explain the relationship, particularly when that relationship and the resulting trends in cash flows, are relatively complex.

It's where you're headed that counts, and as this is operating cash flows, starting with operating profit minimizes the complexity of adjustments and is less circuitous. It also avoids merely repeating at the top of the cash flow statement the items below operating profit on the income statement.

Investor observations

Presentation of operating cash flows

Investors were asked if they have a preference for whether the reconciliation of a profit or loss figure to operating cash flows is shown at the top of the cash flow statement, or in a note.

Splitting the operating cash flow portion of the statement into a note is a legacy of common practice under UK reporting requirements which some have carried over into their IFRS reporting. If the statement is split, the note containing information on operating cash flows is typically referenced on the face of the cash flow statement quite clearly.

While most investors prefer all sections of the cash flow statement to be shown together, the strength of opinion regarding this varies.

Reasons for preferring a combined statement include:

- the reconciliation of profit or loss to cash flows from operations is one of the most important pieces of information a company gives and it should not be 'stuck in a note as if it doesn't matter'.
- splitting the statement makes the information less easy to use than combining it in a single continuous statement. Combining it saves investors time.
- many investor models for analysis and valuation work on a continuous basis, showing what might be referred to as a cash waterfall starting with the derivation of operating cash flows.
- putting all sections of the cash flow statement in one place is particularly helpful to investors when viewing reports on electronic media.
- showing operating cash flow as part of the primary cash flow statement is the most prevalent approach internationally.

One investor even commented that 'only the British split the statement'.

Start of the reconciliation to operating cash flows

Investors were also asked if they had a preference for which profit or loss figure companies use to start their indirect method reconciliation to operating cash flows.

Several investors noted that the variety of approaches taken makes peer comparison very difficult. It is therefore essential that the starting point can be easily reconciled to the corresponding amount on the income statement.

"Presenting a cash flow statement that begins with operating profit and reconciles to operating cash flows is a simple method of providing investors and analysts with the information they want in a single source."

Andy Agg, National Grid

"If the Lab's focus is about improving the usability of reported information, combining the cash flow statement information in a single continuous statement does exactly that."

An equities investor

"We shouldn't have to look around to see how the pieces fit together. Clearly [operating cash flows] could fit at the top of the statement – we should be asking why separate it?"

A credit analyst

Operating income or loss

Most investors prefer the statement to start from a sub-total on the income statement that represents 'operating' income or loss. While operating income or loss is not defined in a standard manner, such a figure, as long as it can be clearly linked to the same amount on the company's income statement, is preferred. It was acknowledged, however, that the US Securities and Exchange Commission (SEC) has challenged the reporting by companies of cash flows starting from anything other than net profit or loss.

Reasons given by investors for starting with operating income or loss generally centre on the simplicity this offers. Some investors observe that using net profit as the starting point effectively 'doubles the length' as more non-cash items are required to be eliminated and then replaced with the corresponding cash flows. Investors also note that a long list of non-cash adjustments representing income statement amounts being removed or differences between income statement and cash amounts, does not really seem to fulfil the objective of presenting a statement on cash flows. Starting at net profit or loss can make it more difficult to ascertain which items are cash flows.

Investors generally want to be able to derive operating income or loss if the starting point on the cash flow statement is below such a subtotal on the income statement. This could be achieved by listing separately in the reconciliation the adjustments to add back items between the starting point and operating income or loss, for example tax and interest expense, and even showing a subtotal of operating income or loss. This is illustrated by Xchanging, which starts its reconciliation with loss before tax, then adds back net finance cost to show a subtotal for operating profit, which is then reconciled to operating cash flows. (See Example disclosure 2.)

Also discussed as potential starting points were EBITDA, as being even closer to operating cash flows than operating income or loss, and EBIT, which is the starting point for the internal templates of some investors. These measures are often considered by investors relative to operating cash flows in order to assess cash conversion (operating cash flow as a percentage of EBITDA, for example).

However, EBITDA is not likely to be an acceptable starting point for the reconciliation to operating cash flow under the requirements of IFRS currently. It is not defined by IFRS and is not generally shown on the income statement.

The relationship between EBITDA and operating cash flows could however be shown outside of the financial statements, for example in the financial review, and this is the approach taken by Vodafone in their reconciliation of EBITDA to the decrease in net debt, featured in *Lab project report: Net debt reconciliations*.

Net profit or loss

A small minority of investors prefer the reconciliation to operating cash flows to start with net profit or loss. For some, net profit is easy to follow as it is clear and ensures a continuation of the bottom number of the income statement being the top of the cash flow statement. This is the case for companies that continue to split their statement of comprehensive income to show a separate income statement that ends with net profit or loss.

A further concern is that it could be a slippery slope to start somewhere further up the income statement, as the starting point should be very obvious, which net profit or loss generally achieves.

Another investor commented that the boundaries between operating and investing items can be blurred. Starting with net profit can provide greater transparency on the full spectrum of potential operating cash flow items, including those for which the company removes the related amounts from net profit and treats the corresponding cash as investing or financing.

"We start our cash flow statement from loss before tax from continuing operations, but then show clearly how adding back net finance costs means that effectively we reconcile operating profits to operating cash flows. This helps to emphasise the finance cost attributed to net debt, useful in considering the difference between amounts attributable to enterprise versus equity value."

David Bauernfeind, Xchanging

Reconciling items

Investors were asked to comment on reconciling items that they like to see shown separately under the indirect method of disclosing operating cash flows.

Generally, investors want clear descriptions of adjusting items that can be matched up to items on the balance sheet or income statement to which they relate, and the normal caveats of not combining significant unrelated items or labelling significant amounts as 'other' apply.

Important items mentioned (apart from tax and interest covered in the next section) include depreciation and amortisation (D&A), working capital, pensions and other benefit obligations, and equity-accounted earnings.

"Providing in the cash flow statement the changes in individual components of working capital is particularly important for smaller public companies where analysts have less time to spend in reviewing accounts than for larger companies."

David Bauernfeind, Xchanging

Depreciation and amortisation

Starting the reconciliation with operating income or loss ensures that D&A needs to be removed as a non-cash item.

Comments from investors focused on the following:

- The total D&A amount can be unclear from the income statement and notes, particularly if it is spread over various lines of the income statement and is not clearly disclosed. Therefore, investors often look to the cash flow statement for the full amount of depreciation and amortisation.
- Most investors are satisfied that D&A be aggregated. In particular, investors compare this to capex.
- However, one investor highlighted that the amortisation of intangibles acquired in a business combination should be shown separately as this is on a different basis from internally generated items accounted for at cost and included in capex, and involves amortisation of items that are not normally capitalised.

Working capital changes (WCC)

Most investors want to see separate disclosure of changes in individual components of working capital, in order to:

- understand which components are driving the overall change in working capital. Separate movements need to be shown particularly where there are individually large changes. Individual components are usually subject to different forces and may give different signals for analysis, for example impairments of receivable balances versus management of trade payables.
- develop a normalized view on cash flow. This is assisted by seeing historical trends of separate WCC.
- understand the company's definition of working capital, as this term is not defined in a standard manner. Listing the changes in separate components can provide clarity on what is managed by the company as working capital. While most investors normally include trade receivables, inventory and trade payable movements, some observe that the specific components of working capital should depend on the nature of the business.
- make adjustments. Investors may also make adjustments to cash measures if they do not agree with the company's definition of working capital. The components are needed to identify the respective adjustment amounts. For example, some investors exclude or adjust for changes in advance payments, or restructuring provisions, if material.
- calculate subtotals. A subtotal of funds from operations (FFO) is often used in credit analysis, calculated as operating cash flows before WCC. It is necessary to understand the individual components of the company's definition of working capital to decide which should be included in the amount added back to operating cash flows.
- corroborate analysis. While receivable and payable days are calculated separately by investors, showing the separate WCCs helps them to corroborate their analysis which can be important in establishing proof for an investment case.

"Consistency on the main items is important and could identify that material issues for peers do not impact the reporting entity. The problem with materiality is that it appears that items are only regarded as material once something goes wrong. If there is a problem, we want a history of how the problem evolved. If there is no track record or history of disclosing the information, it is difficult to evaluate management's assertion that an event is a 'one-off'."

A credit analyst

"I prefer the components of working capital changes to be separately disclosed. This allows me to make adjustments where I would use a different definition of working capital."

A credit analyst

"We separately disclose movements in the components of our working capital, as this gives clarity over the constituent movements and leads to a better understanding of the operating cash flow performance within the business."

Tony Chanmugam, BT Group

Pensions
If top-up payments are significant, or there is a significant difference between amounts charged to earnings and paid in cash, then investors prefer to see a separate adjustment for pensions and other benefit obligations. Some prefer to see the cash contributions listed separately from the earnings amount added back to operating profit or loss rather than a net difference.

Equity accounted earnings
Several investors want an understanding of the amount of earnings from equity-accounted entities versus the amount received in dividends. Some adjust earnings measures to remove any amount in excess of the amount received in dividends from equity-accounted entities as a return of investment rather than a return on investment. These issues point to the value of making clear the equity method earnings and the dividends received.

Tax and interest

Investors were asked for views on the presentation of tax and interest in the cash flow statement. All investors indicating a view on this want separate amounts of tax and interest paid to be listed in the cash flow statement.

Amounts paid are generally shown if the starting point of the reconciliation is a profit or loss measure that is before tax and interest. Even if the starting point is net profit or loss, investors prefer to see both the income statement amounts added back, and the amounts paid subtracted, rather than net differences.

Separate presentation is important because gross amounts of expense and payments can 'bounce around' a lot and the effects of the net change need to be isolated to understand which element is driving the change. Tax timing in particular can be very different between earnings and cash amounts.

It is also considered very problematic to compare companies under IFRS to US companies. In the US, changes in accrued tax and interest are included in working capital changes but cannot generally be separately identified. In the context of calculating FFO (operating cash flow before working capital changes) an extensive effort is made by some analysts to estimate under IFRS an adjustment to working capital changes so that it is comparable to the US approach. Disclosure by companies of changes in accrued interest and tax amounts would be helpful in making estimates less prone to error.

Some investors seek to compare interest received and paid to the related income statement amounts and then relate these to the associated components of net debt. They highlight a general difficulty in relating such amounts needed to build confidence that amounts are understood across the statements and seem sensible and in line with expectations. Building such amounts into net debt reconciliations to show the separate developments relating to interest, including profit or loss amounts and cash amounts, could help address this.

Investing cash flows

Investors were asked which separate elements of investing cash flows are important to have disclosed for their analysis. There was a general sense that items should vary to identify activities significant to a company's industry and its specific activities.

Items mentioned as important include:

- Acquisitions and disposals – these need to be shown separately as they have separate returns associated with them. Such transactions are also considered for their impact on year on year comparability, and related changes in the perimeter of consolidation.
- Capex: Gross amounts of capex and any asset sales should be shown, and separate amounts for tangible and various intangibles, such as software. Additionally, investors would like to see the company's view of maintenance and growth amounts, as maintenance is often not considered discretionary whereas growth is, with both having implications for developments of net debt.
- Some investors commented on companies needing to provide enough detail so that investors could be clear that nothing is hidden. If items are material they should be listed separately, including amounts that could be considered to be non-core activities, for example derivative or other financial trading activities of a manufacturing company, or the purchase of investments that are then contributed to the pension fund, which is treated as a non-cash transaction.

"Separate disclosure of capex, acquisition and disposal cash flows is very useful. It would also be useful to see maintenance capex separately from growth capex."
A fixed income investor

Other non-cash transactions were also mentioned, such as giving a clear indication of finance lease additions that, as they are not cash flows, are not reported in the cash flow statement under IFRS. Investors also want an accurate figure for the cost of acquisitions, including acquired debt. Where material, both finance lease additions and debt assumed in acquisitions would be covered in a net debt reconciliation *(See Lab project report: Net debt reconciliations.)*

Subtotals of cash flow measures

Investors were asked whether additional subtotals of cash flows would be helpful – additional to operating, investing and financing categories in the cash flow statement, whether within the cash flow statement, or in separate summaries of cash flow information reported elsewhere.

Most analysts did not suggest doing this as they generally work out amounts by their own definitions. They feel that companies would need to be very clear on components of additional subtotals so amounts could be reclassified for analysis if investors considered this to be necessary.

Other investor responses include:

- It can be difficult to relate operating profit or loss before exceptional items to cash flows that include such items. A potential solution discussed is the regular disclosure of cash amounts related to any profit or loss amounts highlighted as being 'unusual', 'exceptional' or referred to by a similar term.
- Showing a company's defined free cash flows (FCF) could be helpful. Views however differ between investors on whether to split capex and deduct maintenance capex, but not expansionary capex. Company views on this split could provide some insight.
- Where metrics are set as strategic targets, these should be shown, as well as how they are calculated and whether targets are achieved. Some of these may relate to ratios that are of interest to rating agencies. Disclosure of such measures confirms this is a focus for the company, and credit/fixed income investors are very interested in these. It was commented that continental European companies often provide more helpful information on this than companies in the UK.
- It could be interesting for companies with significant pension deficit payments to disclose a cash flow measure before such payments.

Example disclosure 1

Cash flows from operating activities

National Grid, March 2012 Annual Report, pages 120 and 124

Shows the reconciliation of operating profit to net cash flow from operating activities at the top of the cash flow statement, rather than in a note.

Shows separate adjustments for pensions and provisions, and shows cash flows related to exceptional items.

Shows taxes and interest paid on the face of the cash flow statement (interest paid is shown within cash flow from financing activities).

Consolidated cash flow statement

for the years ended 31 March

	Notes	2012 £m	2011 £m
Cash flows from operating activities			
Total operating profit	1(b)	**3,539**	3,745
Adjustments for:			
Exceptional items, remeasurements and stranded cost recoveries	3	**(44)**	(145)
Depreciation, amortisation and impairment		**1,282**	1,245
Share-based payment charge		**24**	25
Changes in working capital		**146**	185
Changes in provisions		**(116)**	(93)
Changes in pensions and other post-retirement benefit obligations		**(386)**	(304)
Cash flows relating to exceptional items		**(205)**	(147)
Cash flows relating to stranded cost recoveries		**247**	343
Cash generated from operations		**4,487**	4,854
Tax (paid)/received		**(259)**	4
Net cash inflow from operating activities		**4,228**	4,858

Consolidated income statement

for the years ended 31 March

	Notes	2012 £m	2012 £m	2011 £m	2011 £m
Revenue	1(a)		**13,832**		14,343
Operating costs	2		**(10,293)**		(10,598)
Operating profit					
Before exceptional items, remeasurements and stranded cost recoveries	1(b)	**3,495**		3,600	
Exceptional items, remeasurements and stranded cost recoveries	3	**44**		145	
Total operating profit	1(b)		**3,539**		3,745

Starts the cash flow statement with operating profit as shown on the consolidated income statement, as this more closely relates to operating cash flows.

Example disclosure 2

Cash flows from continuing operations

Xchanging, 2011 Annual Report, Pages 72 and 73

Shows how operating profits are derived, as this is not used as the starting point.

Shows separate adjustments for changes in the components of what the company manages as its working capital.

Cash generated from operations

	Note	2011 £m	Restated 2010 £m
Loss before tax from continuing operations		**(2.5)**	(7.6)
Net finance cost	9	**9.1**	4.5
Operating profit/(loss) from continuing operations		**6.6**	(3.1)
Adjustment for non-cash items:			
– Impairment losses	6	**14.6**	57.8
– Employee share-based payment charges	8	**3.3**	2.0
– Depreciation of property, plant and equipment	5	**11.0**	9.2
– Amortisation of other intangibles	5	**20.6**	23.3
– Amortisation of pre-contract costs	5	**1.8**	1.5
– Loss on disposal of property, plant and equipment and other intangibles	5	**0.8**	0.7
– Loss on disposal of available-for-sale financial assets		**0.1**	–
– Gain from a bargain purchase	6	**–**	(0.1)
		58.8	91.3
Changes in working capital (excluding the effects of business combinations):			
– Decrease/(increase) in trade and other receivables		**22.1**	(2.8)
– (Decrease)/increase in payables		**(19.6)**	5.7
– Decrease in pensions		**(0.6)**	(0.6)
– Increase/(decrease) in provisions		**0.4**	(13.6)
Cash generated from continuing operations		**61.1**	80.0

Starts the cash flow statement with profit (loss) before taxation – a subtotal on the consolidated income statement.

Consolidated income statement
for the year ended 31 December 2011

	Note	2011 Adjusted £m	2011 Adjustments to adjusted[1] £m	2011 Total £m	Restated[2] 2010 Adjusted £m	Restated[2] 2010 Adjustments to adjusted[1] £m	Restated[2] 2010 Total £m
Continuing operations							
Revenue	4	**650.0**	**1.2**	**651.2**	681.8	6.9	688.7
Cost of sales	5	**(584.7)**	**(19.9)**	**(604.6)**	(605.0)	(12.4)	(617.4)
Gross profit		**65.3**	**(18.7)**	**46.6**	76.8	(5.5)	71.3
Administrative expenses	5	**(22.1)**	**(17.9)**	**(40.0)**	(20.7)	(53.7)	(74.4)
Operating profit/(loss)		**43.2**	**(36.6)**	**6.6**	56.1	(59.2)	(3.1)
Finance costs	9	**(14.1)**	**(5.0)**	**(19.1)**	(13.2)	(0.8)	(14.0)
Finance income	9	**10.0**	**–**	**10.0**	9.5	–	9.5
Profit/(loss) before taxation		**39.1**	**(41.6)**	**(2.5)**	52.4	(60.0)	(7.6)
Taxation	10	**(14.2)**	**8.3**	**(5.9)**	(15.3)	0.6	(14.7)
Profit/(loss) for the year from continuing operations		**24.9**	**(33.3)**	**(8.4)**	37.1	(59.4)	(22.3)
Discontinued operation							
(Loss)/profit from discontinued operation	13	**(4.0)**	**8.5**	**4.5**	(0.9)	(50.1)	(51.0)
Profit/(loss) for the year		**20.9**	**(24.8)**	**(3.9)**	36.2	(109.5)	(73.3)

Example disclosure 3

Cash flows from operating activities

BT Group, March 2012 Annual Report, Pages 98 and 102

Shows the reconciliation of profit before tax to net cash inflow from operating activities at the top of the cash flow statement, rather than in a note.

Shows separate adjustments for changes in the components of working capital components, using descriptions found on the balance sheet.

Shows taxes and interest paid on the face of the cash flow statement (interest paid is shown within cash flow from financing activities).

Provides information on significant pension deficit payments.

Group cash flow statement

Year ended 31 March	Note	2012 £m	2011 £m	2010 £m
Cash flow from operating activities				
Profit before taxation		2,445	1,717	1,007
Loss (profit) on disposal of businesses and associates		19	(42)	10
Share of profits of associates and joint ventures		(10)	(21)	(54)
Net finance expense		484	924	1,158
Other non-cash charges		106	78	77
Depreciation and amortisation		2,972	2,979	3,039
Decrease (increase) in inventories		12	(17)	14
Decrease in trade and other receivables		28	408	524
Decrease in trade and other payables		(65)	(378)	(708)
Decrease in provisions and other liabilities[a]		(2,033)	(873)	(591)
Cash generated from operations		**3,958**	**4,775**	**4,476**
Income taxes paid		(400)	(209)	(76)
Income tax repayment for prior years		–	–	425
Net cash inflow from operating activities		**3,558**	**4,566**	**4,825**

[a] Includes pension deficit payments of £2,000m (2011: £1,030m, 2010: £525m).

While the cash flow statement starts with profit before taxation, showing on the cash flow statement the two income statement amounts between this and operating profit results in a reconciliation that is effectively from operating profit to net cash inflow from operating activities.

Group income statement

Year ended 31 March 2012	Notes	Before specific items £m	Specific items[a] £m	Total £m
Revenue	4	**19,307**	**(410)**	**18,897**
Other operating income	5	387	(19)	368
Operating costs	6	(16,602)	256	(16,346)
Operating profit	4	**3,092**	**(173)**	**2,919**
Finance expense	25	(692)	(2,092)	(2,784)
Finance income	25	11	2,289	2,300
Net finance expense		**(681)**	**197**	**(484)**
Share of post tax profit of associates and joint ventures	15	10	–	10
Profit before taxation		**2,421**	**24**	**2,445**
Taxation	10	(584)	142	(442)
Profit for the year		**1,837**	**166**	**2,003**

Project methodology

The overall objective of this project was to explore various voluntary practices and to identify those that investors found to be useful to their analysis, indicating why this is the case and how information is used. Companies are encouraged to consider whether the potential reporting changes arising from this are material and of relevance in the context of the company's own financial reporting.

The Lab has not mapped the comments made by investors against specific reporting requirements as this report is not a technical report, rather one that largely reflects the comments and perceptions of investors. Some aspects of corporate reporting that are mentioned by investors as being useful may already be required.

It is the responsibility of each reporting company to ensure compliance with relevant reporting requirements, including requirements that the accounts give a true and fair view.

Company participation

Five companies volunteered to participate in this project to have the Lab facilitate feedback from investors on the usefulness of specific characteristics of the companies' existing published disclosure on debt and cash flows.

The five companies are:

- BT Group
- National Grid
- Royal Dutch Shell
- Vodafone
- Xchanging

The Lab worked with these companies to develop a list of questions to be discussed with investors, and identify excerpts from their accounts to be provided alongside the questions to help illustrate the various points raised. The section of this report on 'Investor observations' reflects the questions raised for discussion with investors.

Investment community participation

The most significant portion of the project research was gathered during a series of mainly face-to-face discussions with members of the investment community, taking place from February to June 2012. Discussions lasted on average just over an hour. Investors were asked to comment on the importance of disclosure on debt and cash flows, and their use of specific information based on the series of questions developed and the examples from disclosure of the five participating companies.

The following organisations contributed views from the investment community in their capacity as investors or other analyst organisations that work in the interest of investors:

- Allianz Global Investors
- Blackrock Investment Management
- CFA Institute
- CFA Society of the UK
- CreditSights
- Deutsche Bank
- Fidelity Management and Research
- Fidelity Worldwide Investments
- Fitch Ratings
- Goldman Sachs Asset Management
- Henderson Global Investors
- Institutional Investment Advisors
- JP Morgan
- Moody's Investors Service
- ShareSoc
- UBS

These 16 organisations cover a wide spectrum of use of reported information by institutional and retail investors, broker sell-side and independent research organisations, credit rating agencies, analyst associations and other advisers. A total of 19 meetings were held and one written submission was received.

In all, views were obtained from over 30 individuals, and these were split relatively evenly between individuals having an equities and fixed income or credit focus. Most participants follow companies or manage funds directly, and these were complemented by a few accounting specialists. While approximately half of the investors that provided input to the project commented from the perspective of following one or more of the five participating companies, others commented more generally from the perspective of corporate equity and fixed income or credit analysis.

In this project, the Lab did not attempt to navigate to an agreed answer on each question or point discussed, nor was there an attempt to strive for consensus among investors, or between investors and companies. The meetings were more discussion based, spending more time on aspects that participants showed a relatively greater interest in, to understand better whether and how various characteristics of information are used by individual investors.

The objective of these discussions was to reflect on the various considerations noted by investors as being important relative to their analysis of debt and cash flows, and to obtain explanations where possible of how information is used, so that this could be reported on by the Lab.

This report shares the insights gained from the investor meetings and the additional written input received. It is hoped that companies will consider whether the suggested approaches described are relevant to their own circumstances.

The Lab's testing of investor input used the December 2010/March 2011 disclosures of the five companies as illustrative. However, this report also includes the updated December 2011/March 2012 disclosures as being equally illustrative of the points highlighted.

Project context: focusing on what is important

Recent FRC guidance published in *Cutting clutter: Combating clutter in annual reports (2011)* and *Financial Reporting Review Panel: Annual Report 2011* and *Financial Reporting Review Panel: Annual Report 2012* has encouraged all those involved in preparing financial reports to exercise judgement to determine and apply a quantitative threshold and qualitative assessment for materiality in relation to disclosures.

A more rigorous approach to materiality judgements might result in financial reports that are more meaningful, focused and relevant to investors because inconsistencies and superfluous material will have been avoided. Clutter undermines the usefulness of annual reports and accounts by obscuring important information and inhibiting a clear understanding of the business and the issues it faces.

In July 2012, the FRC, in partnership with the European Financial Reporting Advisory Group (EFRAG) and the Autorité des Normes Comptables (ANC), published a Discussion Paper *Towards a Disclosure Framework for the Notes*. That paper forms an essential part of the full disclosure picture but is deliberately limited in scope. The FRC continues to consider how a disclosure framework might contribute to improvements in corporate reporting, and has recently published a Discussion Paper *Thinking about disclosure in a broader context* which considers disclosures more holistically.

Other reports published by the Lab recently:

November 2012: *Debt terms and maturity tables*

September 2012: *Net debt reconciliations*

June 2012: *A single figure for remuneration*

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