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EPSAS WG 19/09.1

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EPSAS Working Group meeting

To be held in Luxembourg

on 18-19 November 2019, starting at 09:30

Item 4 of the Agenda

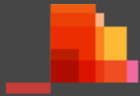
Pilot EPSAS Screening Report

IPSAS 2 – Cash flow statements

Paper by PwC on behalf of Eurostat
- for discussion -

This document pilots an approach to screening the consistency of individual IPSAS standards with the draft EPSAS Conceptual Framework, with a view to informing future EPSAS standard setting. The WG is invited to discuss the approach taken, and to comment on the analysis provided and on the conclusions reached.

Pilot EPSAS screening report



IPSAS 2 - Cash flow statements

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Background

Objectives

We refer to the general introduction to the pilot EPSAS screening reports that covers the following elements:

- Key objectives of EPSAS.
- Standard setting process in the public sector.
- Purpose and scope of the screening reports.
- Approach of the screening reports.
- European public good.
- Common elements considered when preparing the reports.

General introduction to IPSAS 2

IPSAS 2 ‘Cash flow statements’ is based on International Accounting Standard IAS 7 ‘Statement of Cash Flows’, issued by the International Accounting Standards Board (IASB). In developing IPSAS 2, the IPSASB applied its ‘Process for Reviewing and Modifying IASB Documents’ that identifies public sector modifications where appropriate. This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring that the unique features of the public sector are addressed.

The cash flow statement is one of the primary statements in the financial reporting (along with the statement of financial position, the statement of financial performance and the statement of changes in net assets/equity).

It presents the generation (cash inflows) and use (cash outflows) of ‘cash and cash equivalents’ by category (operating, investing and financing) over the reporting period.

Cash comprises cash on hand and demand deposits. Cash equivalents are short-term (maturity of three months or less from the date of acquisition), highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Information about the cash flows of an entity is useful in assisting users to:

- ascertain how a public sector entity raised the cash it required to fund its activities and the manner in which the cash was used;
- predict the future cash requirements of the entity and its ability to generate cash flows in the future as well as its ability to fund changes in the scope and nature of its activity;
- assess the entity's compliance with legislation and regulations (where appropriate, depending on the jurisdiction).

Reference to EFRAG assessment

No specific individual technical assessment of IAS 7, the IFRS equivalent of IPSAS 2, was carried out by the EFRAG, and therefore no specific individual endorsement report was produced.

The EFRAG however provided on 19 June 2002 a positive assessment of all IAS standards existing at 1 March 2002, including IAS 7, as part of the overall introduction of IAS 7 within the EU.

Reference to EPSAS issue paper

No EPSAS issue paper was prepared on the topic of cash flow statements.

Screening of IPSAS 2 Cash flow statements against EPSAS endorsement criteria

Introduction

The EPSAS criteria listed in the EPSAS CF have been used to perform an assessment of IPSAS 2 “Cash flow statements”, published in May 2000 by the IPSAS board (IPSASB).

First, the paper addresses whether IPSAS 2 would meet the qualitative characteristics of the EPSAS framework, i.e. whether it would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information and would not be contrary to the true and fair view principle.

This report then considers recognition, classification, measurement, presentation and disclosure requirements applicable to the cash flows each of the qualitative characteristics of the EPSAS framework.

Further, this paper includes a high-level comparison between the requirements of IPSAS 2 and other international accounting and financial reporting frameworks applied by the public sector entities in various jurisdictions, such as IFRS, ESA 2010 and EU Accounting Rules (AR), bearing in mind the objective of alignment, reduction of cost of implementation and compliance cost.

The findings are presented below and the conclusions are included in the next section of this report.

Relevance

A cash flow statement presented as a primary financial statement and prepared in accordance with the requirements of IPSAS 2 helps users to predict the future cash requirements of the entity, its ability to generate cash flows in the future and to fund changes in the scope and nature of its activities. A cash flow statement also provides a means by which an entity can discharge its accountability for managing cash, including cash inflows and cash outflows during the reporting period.

All values and figures in the cash flow statement have confirmatory values. Moreover, information about the cash flows of an entity is relevant and useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents in the future and the needs of the entity to utilise those cash flows. The economic decisions taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation.

The statement of cash flows should report cash flows during the period classified by operating, investing and financing activities.

Operating activities are the principal revenue or service producing activities of the entity and other activities that are not investing or financing activities. Cash flows from operating activities are primarily derived from the principal revenue or service producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of surplus and deficit.

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing. An entity shall report cash flows from operating activities using either: the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows. Where the direct method is used, IPSAS 2 encourages disclosure of a reconciliation of surplus or deficit to operating cash flows in the notes to the financial statements.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. The aggregate cash flows arising from obtaining and losing control of subsidiaries or other businesses should be presented separately and classified as investing activities.

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity. An entity should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities.

Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a statement of cash flows. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Faithful representation / Reliability

A cash flow statement prepared on the basis of IPSAS 2, when used in conjunction with other information included in the financial statements, provides information that enables users to evaluate the changes in net assets/equity of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities.

The notion of faithful representation and reliability in the EPSAS CF is linked to the qualitative characteristics of completeness, prudence, neutrality, verifiability and substance over form. These are separately discussed below.

Completeness

A cash flow statement should provide a reconciliation between the balance of cash and cash equivalents at the beginning and the end of the period. This reconciliation exercise provides assurance as to the completeness of the flows of cash and cash equivalents during the period.

The cash inflows and outflows reported during the period should be classified by operating, investing and financing activities. These are the only three classes of activities. The standard has clear definitions for these activities that enable users and producers of the GPFSs to distinguish the relevant activities and present them separately.

The impact of non-cash transactions on the assets and liabilities of an entity is not reflected in the cash flow statement. However, a separate disclosure of material non-cash transactions should be presented in the notes, to make sure the information on material non-cash transactions excluded from the cash flow statement is made available to the users.

Prudence

Central to the cash flow statement preparation are the definitions of ‘cash’ as ‘cash on hand and demand deposits’ and ‘cash equivalents’ as ‘short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value’.

In order to be a cash equivalent, an investment will normally have a “short maturity”. The standard suggests that a short maturity period would be a period of three months or less, commencing from the investment’s acquisition date.

The use of a short maturity period, when considering investments as cash equivalents, incorporates the fact that the investments should be so near to cash that there is insignificant risk of changes in value. This prevents classification of other elements in the ‘cash and cash equivalents’ category.

As cash flows are not impacted by estimates and judgments in applying accounting policies, the information provided under IPSAS 2 is prudent. Similar arguments are also included under the QC of neutrality.

Neutrality

Cash inflows and outflows are presented with equal prominence, resulting in a balanced representation of economic reality. The cash flow statement enhances the neutrality of the reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for similar transactions and events. Entities using different accounting policies (for example, as a

consequence of having selected different options in the accounting standards) are able to provide comparable information under IPSAS 2.

Verifiability

A cash flow statement gives a reconciliation between the balance of cash and cash equivalents at the beginning and the end of the period. These opening and closing balance positions reported in the cash flow statement can be reconciled towards the cash equivalents in the statement of financial position of the GPFSs. This reconciliation contributes to the high verifiability of the cash flow information.

For financing activities, the changes in the size and the composition of the contributed capital and borrowings of the entity can be traced back to the statement of financial position and related disclosures for equity and borrowings, also resulting in high verifiability of the information.

For investing activities, the proceeds linked to the acquisition and disposal of long-term assets and other investments reported in the cash flow statement can also be included in a reconciliation exercise with the changes on the asset side in the statement of financial position.

Substance over form

The substance of transactions to be presented in the cash flow statements is reflected in the appropriate classification of cash flows as relating to either the operating, financing or investing activities.

The standard allows enough room for proper reflection of the business model of an entity in the statement of cash flows. For example, operating activities are broadly defined as the activities of an entity that are “not investing or financing activities”. Following this approach, composition of cash flows from operating activities of a government will reflect the nature of its operations and will be different from those of e.g. a financial institution. Although the definition is broad, the standard further describes the operating activities as cash flows primarily derived from the principal cash-generated activities of the entity and provides some examples of cash flows from operating activities in paragraph 22. In a principle-based framework, this guidance should be sufficient to properly reflect the substance of the information provided.

Understandability

Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation.

The statement of cash flows reports cash flows during the period classified by operating, investing and financing activities. This classification basis reflects the way

entities manage the cash flows internally and this contributes to the understandability of the financial information.

Timeliness

To the extent that the reporting entity has implemented the necessary processes and systems, information that should be reported in a cash flow statement can be obtained timely because cash flow amounts are verifiable and are not subject to accounting estimates or judgments.

Comparability

A key objective of EPSAS is to achieve the necessary level of financial transparency and comparability of financial reporting, between and within EU Member States.

IPSAS 2 allows an accounting policy choice for operating cash flows: these are reported using either the direct method or the indirect method. The direct method reports the major classes of gross operating cash receipts and gross operating cash payments. These gross operating cash flows are aggregated to produce the entity's net operating cash flows. This presentation is consistent with that of investing and financing activities.

The same total cash flows from operating activities can be reported under the indirect method too. However, the figure is produced by adjusting the net surplus/deficit to remove the effects of non-cash items (such as depreciation and provisions), changes in working capital (such as accruals and pre-payments, and changes in receivables and payables in the period), and items that relate to investing and financing activities. Some believe this presentation provides less relevant information to the users compared to the direct method; however, it does not require detailed cash flow information to be captured directly in the separate accounting system. The indirect method, widely used in the private sector, allows an appropriate level of comparability between entities. The indirect method allows entities to save time and cost required to implement more sophisticated cash management systems.

The EPSAS issue paper on narrowing down the options within IPSAS classifies the option to use either the direct or the indirect method as 'not a notable option'. It is consistent with the fact that the accounting policy choice is available for reporting the components of net cash flows arising from the operating activities. The amount of the net cash flows arising from the operating activities will be the same under both methods. To conclude, the accounting policy choice to report cash flows from operating activities using either the direct or the indirect method does not compromise the comparability objective in the EPSAS CF.

No other significant accounting policy choices are available under IPSAS 2, except presentation of cash flows from dividend, interest and similar distributions: each should be classified in the consistent manner from period to period as either operating, investing or financing activities. In any case, to enhance comparability, the standard requires separate disclosure of cash flows from interest, dividends and other similar distributions received and paid. Taxes on net surplus are generally classified as cash flows from operating activities, unless they can specifically be

identified with investing or financing activities. The requirements for classifying cash flows into one of the three categories (operating, investing and financing) are clear, therefore leading to better comparability in the reporting.

The fact that cash flow amounts are not influenced by accounting estimates or judgments also enhances the comparability of the cash flow reporting by different entities because different accounting treatments for similar transactions and events cannot be used.

Alignment with ESA 2010 rules

The question is not applicable because ESA 2010 rules do not require the reporting of a cash flow statement. However, there is a requirement to report stocks and movements of cash. More specifically, the reporting of F.2 Currency and deposits is required under the financial account (III.2), other changes in assets accounts (III.3) and balance sheets (IV).

Alignment with IFRS[1]

IPSAS 2 is similar to IAS 7 'Statement of Cash Flows'. The main differences between the standards are summarised below:

- IPSAS 2 contains a different set of definitions;
- IPSAS 2 encourages disclosure of a reconciliation of surplus or deficit to operating cash flows in the notes to the financial statements;
- IPSAS 2 uses different terminology.

Alignment with the EU Accounting Rules

EU AR 1 'Financial Statements' includes separate paragraphs dealing with cash flow statements. The requirements of EU AR 1 are aligned with the requirements of IPSAS 2.

[1] Refer to the IPSAS-IFRS Alignment Dashboard regularly updated by the IPSASB available on https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard_June%202019.pdf

Conclusion

Assessing IPSAS 2 against the criteria formulated in the EPSAS CF

The analysis has not revealed major conceptual issues with IPSAS 2 'Cash flow statements' and has not identified any inconsistency between IPSAS 2 and the EPSAS CF.

Following the screening analysis summarised in the present report, it can be concluded that:

- IPSAS 2 'Cash flow statements' provides relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information needed for making economic decisions and achieving the necessary level of financial transparency and comparability of financial reporting in the European Union;
- the information resulting from the application of IPSAS 2 would not be contrary to the true and fair view principle.

The EPSAS issue paper on narrowing down the options within IPSAS classifies the option to use either the direct or the indirect method as 'not a notable option'. The presentation of operating cash flows using either method provides the same total and therefore does not result in the loss of comparable information about the total operating cash flow of the public sector entities. Indeed, the loss of comparability in presenting the specific components of historical operating cash flows in the cash flow statement is only a presentation issue. It does not have an impact on either recognition or measurement of the elements listed in the EPSAS CF. Keeping this optional presentation of operating cash flows would not prevent the use of IPSAS 2 as a starting point for the implementation of equivalent EPSAS requirements. The same conclusion applies to other classification options available for specific line items, as indicated under the 'Comparability' QC: the total net cash flow amount is the same whatever option is selected.

Assessing whether IPSAS 2 is conducive to the European public good

The assessment of whether IPSAS 2 would be conducive to the European public good addresses the following items:

a) Whether the standard will improve financial reporting;
b) The costs and benefits associated with the standard; and
c) Whether the standard could have an adverse effect to the European economy, including financial stability and economic growth.

These assessments will allow the EU authorities to draw a conclusion as to whether the standard is likely to be conducive to the European public good. If the assessment

concludes there is a net benefit, the standard will be conducive to the objectives of the European public good.

The analysis revealed no reasons why IPSAS 2 would not be conducive to the European public good:

- Transparent presentation of cash flows generated by the public sector entities in the cash flow statement prepared in accordance with IPSAS 2 will provide useful information to the users of the GPFSs and will improve the overall quality of financial reporting in the public sector.
- Implementation of the standard should result in moderate one-off costs and should be relatively cost-neutral on an ongoing basis for preparers. Any one-off costs are expected to be limited to updating internal processes and systems in order to generate the required cash flow information. The requirements of IPSAS 2 only deal with presentation and disclosure and as such do not change existing recognition or measurement requirements in other standards. Cash flow information can be useful to support better budgetary decisions and accountability of the public sector entities.
- The standard will bring improved financial reporting when compared to the heterogeneous reporting requirements currently applied in the EU. As such, its endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship. The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

The assessment concludes that there will be a net benefit of using the requirements of IPSAS 2 as a starting point in implementing the equivalent EPSAS. The standard will be conducive to the objectives of the European public good.