Deutsches Rechnungslegungs Standards Committee e.V.
Accounting Standards Committee of Germany

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Berlin, 29 March 2016

Dear Roger,

EFRAG SDS The Statement of Cash flows – Issues for Financial Institutions

On behalf of the Accounting Standards Committee of Germany (ASCG) I am writing to comment on the above mentioned EFRAG's Discussion Paper (the 'DP').

Overall, we support taking up the subject for further exploration. Whilst we agree with EFRAG's observation that there are claims that the Statement of Cash flows according to current conventions has limited relevance for financial institutions, this does not necessarily lead us to believe that a Statement of Cash flows should be discarded completely. In our opinion, the subject – in particular exploring possible solutions – should be addressed based on evidence. We acknowledge that the different stakeholder groups' views quoted in Chapter 2 of the Discussion Paper may give an indication of the issue in general, but we think that more robust evidence is needed for gaining an understanding as to 'what is broken', before alternative paths, such as those proposed in the DP, can be explored. For example, an in-depth analysis of several financial institutions' cash flow statements in the light of their content and information value could be one possibility for gaining proper evidence. We note that EFRAG itself observed that academic research in respect of finance institutions is not available.

We further note that, although using the label 'financial institutions', for the most part the DP refers to banks, whereas insurance companies and other financial institutions, such as leasing companies are either addressed to some extent or not at all. Furthermore, both terms 'financial institutions' and 'banks' seem to be used thoughout the DP interchangeably, for example in chapter 3. For this reason, we found the DP confusing at times.

When discussing the DP we mainly did so in the context of banks and point out that our answers are focussed on these. Conversely though, we do not want to convey the message that our views mentioned in the appendix to this letter are not valid for financial institutions other than banks as well. If a comment applies to financial institutions in general, we use the term 'financial institutions'.

Please find our detailed comments on the questions raised in the DP in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact Thomas Schmotz or me.

Yours sincerely,

Andreas Barckow
President

Appendix – Answers to the questions of Discussion Paper

Question 1 - Usefulness of the statement of cash flows

The DP discusses the claim that, for some entities, the statement of cash flows in its current format has limited relevance. Do you think the claim is legitimate? If so, do you think that paragraph 3.12 appropriately identifies these entities?

We acknowledge that there are claims that the statement of cash flows according to current conventions has limited relevance for financial institutions. Whilst we agree with EFRAG that presenting the change in cash and cash equivalents is not very meaningful as banks' cash and cash equivalents are extremely volatile by nature, we do not fully agree with some of the statements EFRAG is making in the DP, especially: "[…] *financial institutions can access markets to trade most of their assets with sufficient ease.* […] *The length of the period needed to convert these assets is much shorter than for industrial companies.*" Although selling some or most of the bank's assets with the aim of obtaining liquidity theoretically may be a strategy, we are of the opinion that it is rarely applied in practice. The asset side (liquidity reserve) is relatively stable and driven by regulatory requirements. Of greater importance are the liability side and the ability to raise liquidity on favourable conditions.

We do not agree with EFRAG's definition of the entities that are subject to the proposals made in the DP. The DP's title and executive summary seem to suggest a focus on financial institutions, such as banks and insurance companies, which, in our view, properly circumscribes a wide range of affected entities. In contrast, the definition in para. 3.12 limits this range to entities that engage in deposit-taking and/or in underwriting life-insurance. We believe this definition is too narrow as there are banks, insurance companies and other entities, such as leasing companies, whose cash flow statements are – although outside this limited scope – subject to the same issues that are discussed in the DP.

Question 2 - Possible alternatives

Chapter 3 discuss two alternatives: replacing the statement of cash flows for the identified entities with other requirements, or retain it with targeted improvements. Do you support any of these two proposals? If not, do you have other suggestions?

We do not support either of the two proposals. Please see our answers on questions 3 and 4.

Question 3 - Replacing the statement of cash flows

Assuming the statement is replaced by the identified entities, do you support the introduction of the new disclosures discussed in paragraphs 3.14 to 3.37? If not, what other requirements would you suggest to replace the statement of cash flows with?

Although we acknowledge that there are claims that the statement of cash flows prepared according to current conventions has limited relevance for financial institutions, we do not support alternative 1 that suggests replacing the statement of cash flows with ratios designed to monitor liquidity and liquidity risk by banking authorities.

We acknowledge that these figures provide information about a bank's liquidity and liquidity risk *at a certain point in time*; however, we believe that such information should supplement rather than substitute a statement of cash flows, as otherwise information about the inflows and outflows of cash will get lost, i.e. the changes in cash flows. As we deem this information to be useful and valuable, we would rather keep the statement of cash flows and enhance the banks' financial reporting by providing further disclosures with respect to liquidity and liquidity risk, in addition to those already mandated by IFRS 7. Further, we question the usefulness of point in time information about banks' liquidity as it is typically subject to huge fluctuations within short periods of time. We are unsure what messages would be derived from providing such static disclosures. To mitigate the volatility aspect, we believe that requiring time series of a particular ratio, e.g. the asset encumbrance ratio, might provide more useful information as coverage of a certain period of time would allow users to recognise trends and developments and, thus, better assess the bank's liquidity than a single point in time disclosure as at, for example, the end of the reporting period.

Question 4 - Targeted improvements

Assuming that the statement is retained for the identified entities, do you support the targeted improvements in paragraphs 3.38 to 3.47?

We confine our answer to this question on banks only. In general, we agree that there is a need to enhance the information value of the Statement of cash flows of banks, which we believe can be achieved by targeted improvements. However, we do not believe the majority of the improvements proposed by EFRAG to be overly promising.

The first of the three proposals made by EFRAG to narrowly improve the information value of banks' cash flow statements is to remove the categories within the statement. Although removing the categories appears to be a reasonable idea, we do not expect significant improvements to derive through this measure, as it is already common practice in many banks to report the cash flows arising from their main business activities (including lending and deposit business) within the operating category.

Secondly, EFRAG proposes to report tax cash flows separately. We do not understand the effect resulting from this means, as IAS 7 *Statement of cash flows* already requires cash flows arising from taxes on income to be disclosed separately, and cash flows arising from taxes on other issues do not seem to be significant for banks.

In contrast, we deem the proposal to require certain flows to be reported gross, instead of net, worth being considered further. We generally agree that reporting cash flows on a gross basis provides better information. However, this does not necessarily hold true for cash flows from short term loan business, such as revolving loans, as – due to the high turnover of cash flows arising from those transactions – a gross presentation would result in huge numbers that may distort other important information. Therefore, the dividing line between cash flows reported gross and cash flows presented net needs to be carefully considered and defined when exploring this approach further.

Question 5 - Separate financial statements

The DP discusses general issues with the statement of cash flows for the identified entities. Do you think that there are other issues specific to their separate financial statements? If so, what are they?

It is from this question only that we understand that EFRAG's discussion so far (touching the cash flow statement for financial institutions, the problems linked to that, and possible ways to solve these problems) has primarily been related to and based on *consolidated* financial statements. We do not believe such approach to be appropriate for two reasons:

Firstly, and far beyond the context of financial institutions dealt with in this DP, we note that liquidity and liquidity risk in particular are related to contractual rights and obligations and involve the transfer of cash. Only legal entities can be contractual parties to any transaction, and this should be borne in mind when applying the single entity concept to groups and consolidated financial statements. In other words, according to IFRS 10 *Consolidated Financial Statements* Appendix A, consolidated financial statements represent a group of single economic entities as if they formed one single economic entity. Hence, consolidated financial statements depict an entity based on a pro-forma assumption on the basis of a single entity concept. Therefore, all aspects regarding liquidity and liquidity risk would have to be discussed for single or legal entities first, before addressing the same aspects in a group context. For this reason, we believe question 5 should have been asked the other way round, i.e: “Are there other issues specific to the consolidated financial statements of the identified entities?”.

If one followed our line of thinking, we, secondly, believe that a number of issues will have to be addressed including the scope definition for conglomerates (e.g. predominant approach?) and knock-on issues, such as:

- Should additional liquidity disclosures be made for the whole group or for a defined part of the group that meets the scope definition?
- May specific disclosures for cash flows between the group’s segments be useful?
- Does a consolidated Statement of cash flows provide information value at all, or should Statements of cash flows be provided on segment basis?

Again, these questions apply regardless of whether or not the entity is a financial institution.