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## **Call for Clarity**

*Banks cashflow reports are in a murky state*

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# CALL FOR CLARITY

BANKS' CASHFLOW REPORTS ARE IN A MURKY STATE – URGENT REFORM IS NEEDED TO AVOID A REPETITION OF THE FINANCIAL CRISIS, WARN PROFESSOR PAUL KLUMPES AND PETER WELCH

**T**he financial crisis has prompted an urgent review of banks' financial reporting. Fair value and loan loss provisioning have come under intense scrutiny, and are central to the IASB's financial crisis related projects.

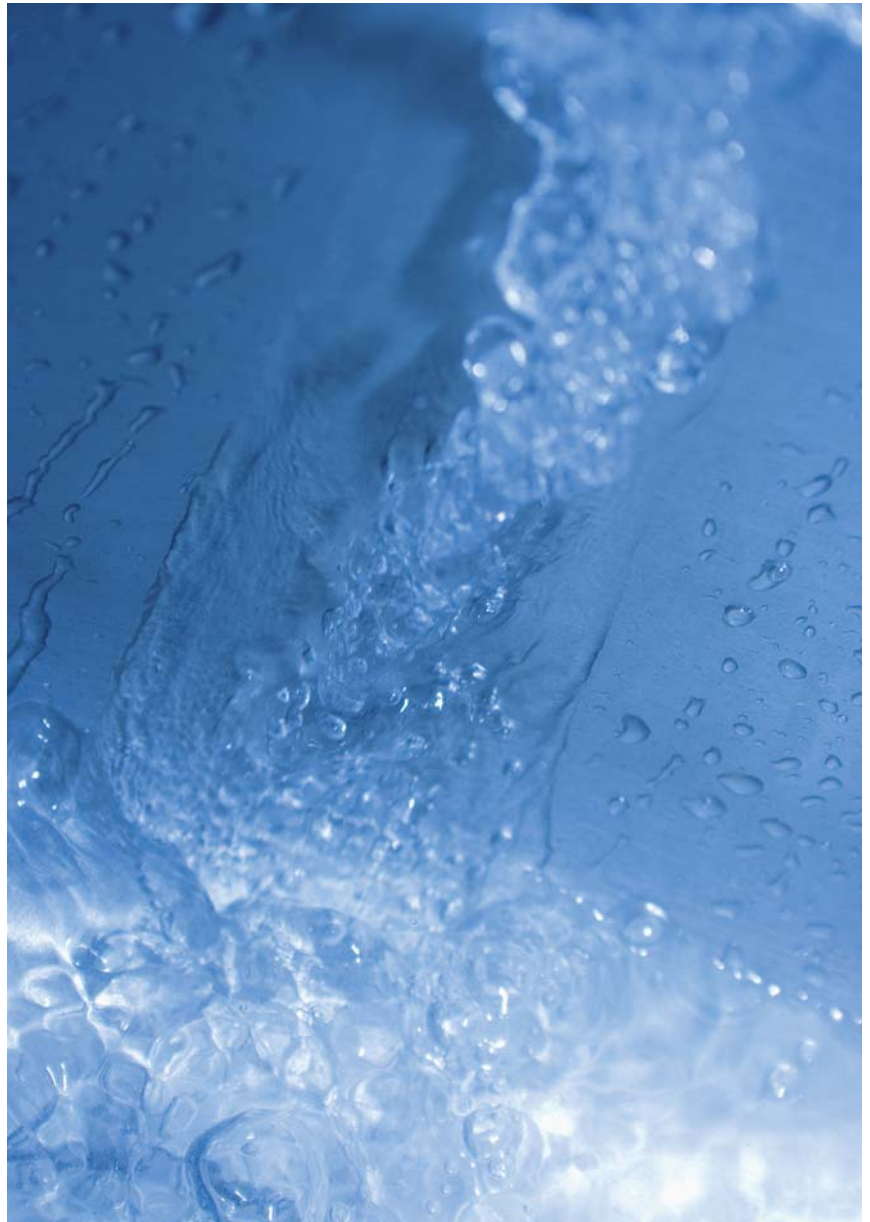
But in all the post-crisis scrutiny, the issue of how banks report their cashflows has been almost completely neglected. This seems astonishing. Corporate collapses teach us that a firm's real financial health is often only revealed by analysis of the cashflows. And arguably, cashflow analysis is even more important to understanding the health and performance of financial institutions. After all, the core business of banks is intermediating cashflows. And, as the crisis has underlined, they are vulnerable both to deteriorating inflows (bad debts represent cash due but not received) and to rapid outflows (deposits withdrawable on demand, the need to refinance wholesale funding as it becomes due).

Research we have recently undertaken found bank cashflow reporting in a sorry state (p69 vol 26, *Journal of Financial Transformation*, August 2009).

Our survey of (how many) large UK and Eurozone banks, all reporting under International Financial Reporting Standards, revealed inconsistencies, a lack of detail, key flows netted off, poor reconciliation with other financial statements and little discussion of the cashflow statement in management commentaries.

The standard IAS 7, *Statement of Cashflows*, governs cashflow reporting for listed companies in the European Union (and other jurisdictions following international standards). IAS 7 applies to all enterprises, including banks, insurance companies and other financial institutions. The standard was introduced in 1992 and has not been subject to major revision since.

According to the International Accounting Standards Committee Foundation's Technical Summary of IAS 7: "The objective of this standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cashflows which classifies cashflows during the period from operating, investing and financing activities."



Surely a lesson from the crisis is that gross flows in loans and repayments, deposits and withdrawals, debt issues and redemptions, all need to be fully disclosed

Summarising the three cashflow categories:

- Operating: principal revenue-producing activities of the entity
- Investing: acquisition and disposal of long-term assets and other investments (including subsidiaries)
- Financing: activities that result in changes in the size and composition of equity and borrowings

Crucially, IAS 7 allows two options for the reporting of operating activities:

- Direct method: major classes of gross cash receipts and payments are disclosed
- Indirect method: profit and loss adjusted for the effects of non-cash transactions, any deferrals/accruals of operating cashflows and any income and expense items associated with investing or financing cashflows

The operating section of a bank's cashflow statement is more complex than that of a non-financial firm. A bank's core services – taking in deposits and other funds and using those funds to make loans and investments – are themselves cashflows. These are also captured in the operating segment as operating asset and liability flows. In broad terms, a bank's operating cashflow is therefore made up of two main components:

- The adjustment of profit (normally profit before tax) for non-cash items, tax paid, etc.
- The operating asset and liability flows – the asset-related movements in loans and investments, and liability-related movements in deposits and wholesale funding such as debt securities.

Despite their importance to understanding a bank's financial health, all the UK and Eurozone banks we surveyed were using the indirect method to report their operating asset and liability flows on a net basis. Yet in most cases, the net change can already be calculated or estimated, by comparing the value of the item (for example, loans and advances to customers) in the end period balance sheet with its value in the preceding period balance sheet. This leaves the cashflow statement communicating little new information.

And the point is far from academic. Surely a lesson from the crisis is that gross flows in loans and repayments, deposits and withdrawals, debt issues and redemptions, all need to be fully disclosed.

### ROCK-VULNERABLE

The volume of gross lending flows is valuable for understanding the maturity of a bank's loan book, and therefore the potential deterioration in credit quality as the book matures. On the liabilities side, gross flows allow the calculation of a bank's rate of liability

turnover, an important indicator of the maturity of a bank's borrowing, and therefore its need for cash. For example, a high rate of liability turnover signals use of short-term funding and therefore a need for frequent funding inflows to replace withdrawn deposits and/or maturing debt securities. This may indicate a potential vulnerability to the kind of refinancing pressures that were central to the problems experienced by Northern Rock and HBOS during the crisis.

### THIN ON DETAIL

In addition to reporting operating flows on a net basis, banks' cashflow statements often lack detail, with key entries either relegated to the notes or not disclosed at all. As a result, the cashflow statement cannot be properly reconciled with other financial statements.

For example, HBOS's cashflow statement for 2007, the year before it required rescuing, is particularly thin. As with the other banks surveyed, the movements in operating assets and liabilities are recorded on a net basis. But perhaps even more surprising is the fact that those core business movements are recorded in single-line entries, totalling £78.9bn and £68.5bn respectively. There is no breakdown by type of operating asset or liability, either in the main statement or in the notes to the accounts.

### LACKING TRANSPARENCY

Even when banks do provide some itemisation of their operating asset and liability flows, it may lack transparency and clarity.

One key finding from the financial crisis was the scale of assets and liabilities held off-balance sheet by some banks through structured investment vehicles (SIVs) and conduits. In theory, the cash movements into and out of such vehicles ought to be captured in the cashflow statement. However, in practice, it is all but impossible to map how the cashflows, through SIVs and conduits, connect to the entries in bank cashflow statements as they are currently structured.

The lack of clarity is also apparent in the crucial area of derivatives reporting. For example, Northern Rock's cashflow statement contained single line entries for the net movement in derivatives payable and receivable. But these simply recorded the net change in the value of derivative assets and liabilities on the balance sheet. There is no explanation of how they map to actual cash movements - such as fees for futures and options, margin calls, etc - related to the use of derivatives.

Our survey also found a lack of consistency in the

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flows captured in the investing section of banks' cashflow statements. Some banks restrict entries to flows related to the purchase and sale of fixed and intangible assets, the acquisition and disposal of subsidiaries, etc. However, five of the seven UK banks surveyed also include flows related to the purchase and sale of financial investments in the investing cashflow section of the statement.

The inclusion or exclusion of financial investments has a massive impact on the reported value of cashflows from investing activities. For example, including flows from available-for-sale financial assets, Lloyds reported an investing cash outflow of £35.1bn in 2008. Excluding the flows, the investing cash outflow would have been only £0.9 bn.

**ANSWERS NEEDED**

In conclusion, bank cashflow reporting is in a mess. In the wake of the crisis, here are five key questions that the International Accounting Standards Board and other accounting regulators should urgently answer:

Why does the IASB continue to permit and condone the apparent widespread use of the indirect method of cashflow reporting when a direct method that shows more detail of relevant cashflows is potentially more useful?

Why hasn't the IASB enhanced the format and presentation of existing required cashflow reports to better tailor the unique circumstances facing banks and other financial institutions (as the German Accounting Standard Board has already done over a decade ago)?

What efforts have the IASB made to help investors reconcile and articulate the cashflow statement with the other key financial statements so as to enable them to disentangle various sources of fair values and earnings?

Why has the IASB failed to define the specific type of 'future cashflows' which it believes are most appropriate to enable investors to make economic decisions, eg, evaluate calls by financial institutions for more capital; is it operating cashflow, free cashflow, or some other measure?

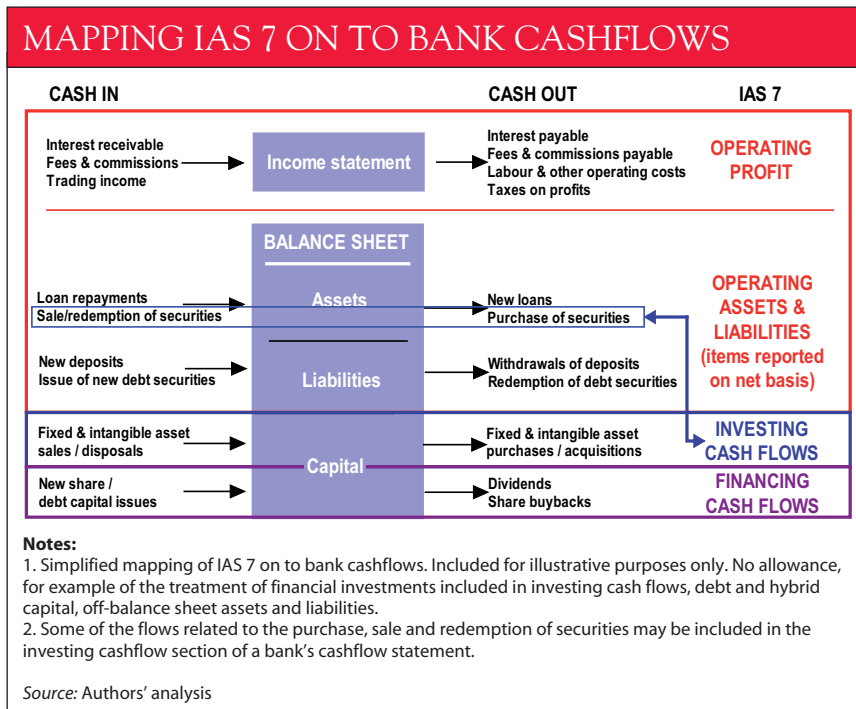
Why has the IASB failed to specify any standard for enhancing the footnote disclosure of key line items to the cashflow statement which are potentially useful to investors (as is already the case for other key financial statements), eg, the future cashflow maturity and liquidity profile of complex derivatives and other commitments?

And while we wait for IASB action on the issue, why are banks and their auditors not voluntarily adopting best practice? At the very least, they should report operating asset and liability flows using the direct method, and include a review of the cashflow statement in the annual report's management commentary. Otherwise, one of the three core financial statements produced by banks will continue to be little better than useless.

**FOOTNOTE**

The UK banks surveyed include Barclays, Bradford & Bingley, HBOS, HSBC, Lloyds TSB, Northern Rock, and RBS. The Eurozone-based banks are Banco Santander, BBVA, BNP Paribas, Crédit Agricole, Deutsche Bank, ING, UniCredit.

It is all but impossible to map how the cashflows, through SIVS and conduits, connect to the entries in bank cashflow statements as they are currently structured



### HBOS CONSOLIDATED CASHFLOW STATEMENT 2007

	2007 £m	2006 £m
Profit before taxation	5,474	6,706
Adjustments for:		
Impairment losses on loans and advances	2,012	1,742
Depreciation and amortisation	1,402	1,192
Goodwill impairment	5	55
Interest on other borrowed funds	1,229	1,157
Pension charge for defined benefit schemes	146	164
Cash contribution to defined benefit schemes	(295)	(860)
Exchange differences	(769)	3,157
Movement in derivatives held for trading	(1,487)	4,081
Other non-cash items	45	(902)
<b>Net change in operating assets</b>	<b>(78,863)</b>	<b>(61,268)</b>
<b>Net change in operating liabilities</b>	<b>68,470</b>	<b>44,743</b>
<b>Net cash flows from operating activities before tax</b>	<b>(2,631)</b>	<b>(1,033)</b>
Income taxes paid	(895)	(991)
<b>Cash flows from operating activities</b>	<b>(3,526)</b>	<b>(2,024)</b>
Cash flows from investing activities	(289)	(1,643)
<b>Net decrease in cash and cash equivalents</b>	<b>(3,517)</b>	<b>(5,773)</b>
Opening cash and cash equivalents	8,191	13,964
<b>Closing cash and cash equivalents</b>	<b>4,674</b>	<b>8,191</b>
<b>Analysis of cash and cash equivalents</b>	<b>2007</b>	<b>2006</b>
	<b>£m</b>	<b>£m</b>
Cash and balances at central banks repayable on demand	1,061	663
Loans and advances to banks with an original maturity of less than three months	3,613	7,528
<b>Closing cash and cash equivalents</b>	<b>4,674</b>	<b>8,191</b>

**Notes:**  
 1. Operating asset and liability entries highlighted by authors.  
 2. Breakdown of cash flows from investing activities and cash flows from financing activities on the following page of HBOS's annual accounts, but no breakdown of the change in operating assets and liabilities.

Source: HBOS 2007 Report & Accounts