Investor view

Insight from the investment community

How to win the competiton for capital

Cash and debt disclosures

In the economic downturn and with the continued strain on the availability of financing there is real competition for capital in the market. Investment professionals tell us that companies can improve their chances of securing the right funding at the right price with some simple voluntary disclosures. In this investor view, we bring together the key messages on cash and debt reporting that we hear from investors, and describe how management can improve their voluntary disclosures to better communicate with the capital markets.

Key issues

Investors tell us that without good disclosure, "the cost of funding goes sky high"; companies that do not make their cash and debt disclosures clear and accessible risk a struggle to raise capital or borrow funds.

Investors have highlighted three key areas from where management can make small changes to disclosures that would have a significant impact on their ability to compete for ever more scarce capital in today's market:

- Cash
- Net debt reconciliations
- Debt

So why are these disclosures important to investors, and what might good practice disclosure look like for your entity?

Cash

Cash flow information is critical for investors, not simply as a critical input to the valuation of entities, but because it allows them to understand management's ability to service the entity's working capital requirements and debt position, and any risks associated with it.

Here are some areas where current reporting can be enhanced.

Cash flow statement – Historical cash flow data is the basis for investors' assessment of the adequacy of future cash flows to meet working capital and funding requirements. Yet investors tell us that "understanding cash flow reporting is like doing a jigsaw with half the pieces missing and without the box".

Investors are not technical accountants. They tell us that they would like more meaningful

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descriptions of the adjustments made to derive operating cash flow so that these can be related to items on the balance sheet. They also say they would find it more helpful for the reconciliation of profit or loss to operating cash flow to start at the operating profit line (or pre-tax profit line) rather than at net income. This would simplify the disclosure and remove the need for spurious reconciling items, which may need to be both eliminated and then added back to arrive at a total for operating cash flow.

Capital expenditure – How much of an entity's capital expenditure is required to keep things ticking over? How much is being used to grow the business further? Understanding the split between maintenance and growth capital expenditure is important to an investor. This is partly because it gives an indication of the growth opportunities available to management; but of equal importance in tough economic times, it gives insight into those expenditures over which management has discretion and those that would be harder to postpone.

Most entities disclose one number for capital expenditure in the investing section of the cash flow statement (albeit split between tangible and intangible elements). Investors would like disclosure of capital expenditure to be separated into 'maintenance' and 'growth' spend, as investors see working capital as a key funding need.

Segmental information - Segmental cash flow information is highly valued. One analyst told us: "It is rare to see good cash flow reporting at segment level. When I see it, I sing hallelujah'."

Many investors believe that multi-segment entities should use the reportable segment as the unit of analysis for providing cash flow information.

Our research indicates that, in addition to existing lines, the cash and debt-related lines that investors look for on a segmental basis include:

- debt;
- operating cash flow;
- working capital; and
- operating capital employed.

Repatriation – Investors need to see clear disclosure of any restrictions on the repatriation of cash that might impede the ability to meet future financing needs.

Net debt reconciliation

An analyst recently told us, "Without a good net debt reconciliation, we are flying blind". It is an easy way of assessing whether an entity that seems to have had a significant increase in cash has, for example, achieved this only by taking on a corresponding increase in debt.

Without a net debt reconciliation, investors struggle to understand the impact of foreign exchange movements arising on debt, the value of debt acquired or disposed through business combinations, the impact of fair value and fair value hedge adjustments. Net debt reconciliations are not required by financial reporting standards, but investors tell us that entities that provide one really set themselves apart.

While there is no standard definition of net debt, it generally includes the entity's borrowings, including finance

leases, less cash and cash equivalents. Some entities also include deficits on defined benefit pension plans and an adjustment for operating lease obligations. The inclusion of other debt-like liabilities provides additional insight into entities' significant expected future cash outflows. This variation means that it is important for management to explain clearly what it means by net debt and to keep that definition consistent over time. Having an accounting policy for net debt would be very useful.

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Debt

In addition to the net debt reconciliation, investors would like to see enhanced disclosures around:

Maturity information – Investors tell us that they need a comprehensive maturity table for all material components of debt, showing both the contractual maturity of each type of debt and when management expects it to be repaid (if different). Rather than reporting using broad buckets (for example, two to five years), investors are looking for detail of the debt repayments that fall due every year (for a minimum of five years) as well as underlying par values and currencies of debt.

Investors find it difficult to reconcile the numbers presented in the maturity schedules to the carrying values in the balance sheet. It would be a significant improvement if management could help them to tie the two sets of data together, showing principal and interest payments separately, and reconciling to the balance sheet (that is, showing adjustments for measurement at fair value, discounting, fair value hedges, swaps etc.)

Covenant restrictions and terms – Financial reporting standards require disclosure of any defaults or breaches of loan agreement terms that are not resolved by the period end. Additional detail of the terms and measurement of the principal covenants in place, not only when breached, provides investors with an understanding of the restrictions in place and the entity's compliance. Investors focus not only on whether covenants have been breached, but what those covenants and restrictions are, and the risk that they may be breached in the future. Disclosures on the key covenants for an entity's finances are of much greater value to the investor's decision-making process than a statement that there haven't been any breaches in the past.

Details of average debt balances – Another easy win is to disclose average debt balances throughout the year, rather than just the year end snapshot, to enable users to understand the debt position over the year.

For more detail on these themes and other insights from the investment community, visit pwc.com/ifrs and search 'Investor views'.

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