Statement of Cash Flows: Time for Change! O Whitfield Broome. Financial Analysts Journal60. 2 (Mar/Apr 2004): 16-22.

Abstract (summary) The statement of cash flows is one of three statements required for financial statements to be in accordance with generally accepted principles of accounting (GAAP). The content and structure of the statement are specified in Statement of Financial Accounting…

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Full text The statement of cash flows is one of three statements required for financial statements to be in accordance with generally accepted principles of accounting (GAAP). The content and structure of the statement are specified in Statement of Financial Accounting Standards (SFAS) No. 95, Statement of Cash flows, issued by the Financial Accounting Standards Board (FASB) in November 1987. The events surrounding the accounting debacles of Adelphia, Dynegy, Qwest, Tyco, WorldCom, and others demand a new look at this key financial statement, particularly because these cases reflect problems with the reporting of cash flows by many corporations. The accounting problems already brought to light raise important questions about current accounting standards for the statement of cash flows and how they are being applied: Is the statement as useful to investors and creditors as it should be? Is it susceptible to manipulation by corporate managers? Can it and should it be improved? Would improvements in the statement increase investors' and creditors' confidence in financial accounting and reporting? The statement of cash flows plays (or should play) a crucial role in fundamental securities analysis. For example, a comparison of operating cash flow with net income is necessary to evaluate current cash flows from income-producing activities. Investing and financing cash flows can reveal how and why a corporation's asset mix and financing mix are changing. Cash flow ratios, such as operating cash flow to current liabilities and operating cash flow to total liabilities, are valuable in evaluating short- and long-term liquidity. Thus, this statement must be as transparent and useful as possible. This article briefly describes the current SFAS No. 95 requirements for the statement of cash flows, cites recent cases of abuse and disinformation involving the statement, and makes significant recommendations for improving the statement. Definitions of Cash Flows SFAS No. 95 requires that cash inflows and outflows be classified into one of three categoriesoperating cash flows, investing cash flows, or financing cash flows (FASB 1987). Examples of cash flow statements are in Table 1 and Table 2. \* Operating cashflows. Operating cash flows are those that are related to the corporation's operating activities (i.e., those activities reflected in the corporation's income statement). Examples include cash collections from customers, cash received in the form of interest and dividends from investments, cash paid to employees for their services, cash paid to suppliers of inventory, and cash paid for income and other taxes. \* Investing cash flows. Cash flows related to investments in infrastructure and other long-term assets are investing cash flows. Examples include cash paid for property, plant, and equipment; cash paid for long-term investment in securities; cash received from the sale of property or equipment; and cash received from the sale of long-term investments in securities. \* Financing cash flows. Financing cash flows involve the raising of capital for the corporation and returning of cash to creditors and shareholders. Examples include cash received from loans, cash received from the issuance of capital stock, cash payments to pay back the principal of loans, and cash

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payments to reacquire capital stock. The FASB requires that the payment of dividends be included as a financing cash flow, primarily because dividends on a corporation's own capital stock are not included as an expense in the income statement. Cash paid for interest on debt is included in operating cash flows, primarily because interest is an expense in the income statement. Formats for Operating Activities For operating activities, SFAS No. 95 allows two format options-the direct method and the indirect method. (The financing and investing sections of the statement do not reconcile to other numbers reported in the financial statements; therefore, as shown in Tables 1 and 2, these sections are to be prepared under the direct method of reporting.)

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The direct method, illustrated in Table 1, presents separate categories of cash inflows and cash out-flows (e.g., cash collected from customers and cash paid to suppliers), with the difference reported as net cash flow from operations. The indirect method, shown in Table 2, is essentially a reconciliation of the net income reported in the income statement with the cash flow from operations. The adjustments should include the noncash items reflected in the income statement (e.g., depreciation expense and accrued salaries expense) plus operating cash inflows and outflows for the period that were not included in the income statement (e.g., collections of amounts owed by customers from sales of prior periods and payments of expenses in advance of their recognition in the income statement). When the direct method (Table 1) is used, the operating activities section shows net cash from operations as made up of the individual operating cash inflows (i.e., cash collected from customers) and individual operating cash outflows (e.g., cash paid for inventories). In Table 2, net cash received from operating activities is calculated by 10 adjustments. (Corporate statements of cash flows can have many more adjustments; this presentation is intended to illustrate in a concise way how a typical indirect method for operating cash flows might appear.) In SFAS No. 95, the FASB expressed a preference for the direct method but allowed the use of the indirect method for operating activities. If the direct method is used, the FASB requires the inclusion of an additional schedule reconciling net income to operating cash flow. In effect, this schedule presents the operating activities section of the statement of cash flows as if the indirect method had been used. In practice, more than 90 percent of the statements of cash flows prepared by corporations use the indirect method. Corporate managers have justified this choice on the grounds that the direct method is too costly. They ask: Why use both the direct method and the indirect method (which effectively is what the FASB requires by calling for an additional schedule reconciling net income to operating cash flow) when using only the indirect method is allowed? Any additional cost of using the direct method must be compared, however, with the benefits to investors provided by this method.

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Studies have consistently shown that analysts and other users of financial statements prefer the direct method for reports of operating cash flows (e.g., Bahnson, Miller, and Budge 1996). AIMR, on behalf of securities analysts and investment managers, has expressed a strong preference for the direct method (see Knutson 1993). The direct method shows major categories of cash inflows and out-flows, whereas the indirect method only reconciles net income to operating cash flow. The complicated adjustments required by the indirect method are hard for the reader to understand and, in addition, provide corporate managers more leeway for manipulating the statement of cash flows. The adjustments made to reconcile net income to operating cash flow in the indirect method can be confusing to users. In many cases, these adjustments cannot be reconciled to observed changes in balance sheet accounts from the prior year to the current year. If users are unable to understand the detailed, line-item adjustments, they are left with an understanding only of the magnitude of the difference between net income and operating cash flow. The direct method allows for reporting operating cash inflows and outflows by understandable categories. For example, readers can see the amount of cash collected from customers and paid to employees. They can compare these cash inflows and outflows over time for the reporting corporation and also compare them with similar cash flows of other corporations. Investors can thus gain a better understanding of the trends in the major causes of cash inflows and cash outflows within the corporation and can compare these cash flows with those of the corporation's competitors. Could it be that one reason corporations predominantly use the indirect method is to avoid providing this level of understandable detail? Classifications in the Statement of Cash Flows Another issue of concern for analysts and other users of financial statements is the classification of specific cash flows among the three sections of the statement. Because of the conceptually clear distinctions among the sections, sound classification is necessary to communicate the nature and magnitude of operating, financing, and investing cash flows. Capital-raising activities are reported in the financing cash flow section. Infrastructure investments are shown in the investing cash flow section. The operating cash flow section reports the corporation's ongoing cash-generating activities that provide cash for dividends to shareholders and for additional investments in the corporation. Thus, analysts and other financial statement readers have used the operating activities section of the statement of cash flows as a "reality check" on the reliability of the revenues and expenses reported in the income statement, ft is particularly important to the reader of the statement that the operating cash flow section include only cash flows related to the corporation's operations. Abuses of Classifications. Since SFAS No. 95 was issued in 1987, a common belief has existed that, unlike the balance sheet and the income statement, the statement of cash flows cannot be manipulated by management if it is prepared in accordance with GAAP. In 2001 and 2002, however, a number of high-profile cases turned a spotlight on abuses of the statement of cash flows to achieve managerial ends. A brief description of some of these cases can shed light on how important the form, content, and preparation of the statement of cash flows really are to users of financial statements. Tyco International. As Tyco's EPS declined in 2001 and 2002, its managers urged analysts and investors to focus not on EPS but on its strong "free cash flow," defined as operating cash flow less dividends and capital expenditures (see White 2002). In retrospect, we can see that the company's managers were engaging in several types of transactions to increase operating cash flow and thus the amount of free cash flow. The issue in this case is not whether these transactions were legal or illegal but whether they were appropriately reported in the statement of cash flows.

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Maremont (2002) reported that Tyco engaged in transactions for its security alarm business to purchase customer contracts from dealers totaling more than $800 million. The cash paid for these contracts was reported as a cash outflow in the investing activities section of the statement of cash flows. When the customers made payments to Tyco under these contracts, however, Tyco reported the cash received in the operating cash flow section. Thus, all of the cash received from the contracts increased operating cash flow whereas Tyco had, in effect, paid out cash for this stream of inflows. Another method that resulted in increased operating cash flow involved acquired corporations about to be consolidated in Tyco's financial statements. Tyco required some of its pending subsidiaries to accelerate payments for operating expenses-that is, to pay in advance amounts owed to suppliers but not yet due-so that the payments would be reported in accounting periods before consolidation took place. Dow Jones Business News ("Firm Acquired by Tyco . . ." 2002) reported that one acquired company, Raychem Corporation, paid more than $50 million to eliminate amounts due to suppliers before its financial statements were consolidated with Tyco's financial statements. Although the economic effect of these prepayments is to forgo the interest that could be earned on cash that is paid before it is due (which actually reduces real operating cash flows), the effect on Tyco's postmerger consolidated statement of cash flows was to relieve the operating activities section of these pay-ments and increase reported consolidated operating cash flow. Tyco also made loans to top officers that totaled tens of millions of dollars. Some of these loans were later forgiven and converted into a form of compensation to the officers. This compensation was originally reported in Tyco's investing cash flows section, however, and never reported in the operating activities section. Noncash transactions, such as forgiving a loan, if material, must be disclosed in the financial statements so that readers can understand the nature of the transaction and make necessary adjustments when analyzing the corporation's performance. Dynegy and Qwest Communications International. In the first half of 2002, Dynegy announced that it would restate its 2001 financial statements for the effects of complex natural gas trading arrangements. These arrangements are called "round-trip trades" because they involve exchanges of resources with other companies in the industry. In effect, round-trip trades involve the sale and purchase of equivalent amounts of natural resources at the same price with the same party. To increase sales and net income, Dynegy treated the sale side of the transaction as revenue but the purchase side as an invest-ment, not as an expense. The cash received from the sale was reported as an operating cash inflow, but the cash paid for the purchase was reported as an investing cash outflow. In the mandated restatement of its statement of cash flows, Dynegy offset these equivalent cash inflows and outflows, which resulted in a decrease of approximately $300 million in net operating cash flow from the amount originally reported (Sender 2002). Qwest apparently inflated its operating cash flows in a manner similar to that used by Dynegy. Instead of swapping natural resources, however, Qwest swapped network capacity with other companies, including Global Crossing, FLAG Telecom Holdings, and Cable & Wireless. For example, in 2001, Qwest sold telecommunications capacity for approximately $100 million to Global Crossing. At the same time, Qwest paid $100 million for substantially equivalent telecommunications capacity from Global Crossing (Day 2002). The capacity given up was accounted for as a sale, but the capacity received was accounted for as an investment. Cash flow from operations was thus increased, because the cash outflow to acquire capacity equivalent to the capacity "sold" was classified as an investing cash outflow, not as an operating cash outflow. Adelphia Communications Corporation and WorldCom. Adelphia and WorldCom used other techniques to boost their reported net operating cash flows. Adelphia aggressively capitalized labor expenses totaling approximately $40 million in both 2000 and 2001. Although most cable companies routinely treat some of the cost of installing cable service and deploying technicians as an investment, Adelphia apparently exceeded the norm. The effect was to shift operating cash out-flows to the investing activities section of the state-ment of cash flows, with a resulting positive effect on operating cash flow. In 2001 and 2002, in a similar move, WorldCom recorded as capital investments a material amount of operating expenses. The cash payments for these operating expenses were treated as investing cash outflows rather than operating cash outflows (Solomon 2002). Summary of Abuses. One common thread in all of these cases relates to misclassification of cash flows among the three sections of the statement of cash flows. Typically, certain cash outflows that should have been reported in the operating section, or offset directly against operating cash inflows, were classified as investing cash outflows. The companies were thus able to make operating cash flows appear to be greater than they really were.

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Another common thread is that all of these companies used the indirect method for the operating activities section. Adjustments to reconcile net income to operating cash flow were numerous, complicated, and difficult to understand. Such complexity provides a type of cover for manipulation of cash flow reporting that does not meet the objective of financial reporting outlined by the FASB. According to the FASB, the role of financial reporting in the economy is to provide information that is useful to present and potential investors, creditors, and other users in making rational investment, credit, and similar decisions. Financial reporting should provide information to help the users of statements assess the amounts, timing, and uncertainty of prospective cash flows. Information about cash flows should help users understand the operations of an enterprise, evaluate its financing activities, assess its liquidity or solvency, or interpret the earnings information provided. Recommendations for Change The accounting and reporting failures that captured the headlines in 2001 and 2002 make a strong case for a change in the reporting of cash flows. The dichotomy (i.e., "either/or" distinction) between the direct method and the indirect method for presenting the operating activities section of the state-ment of cash flows is a false one. Sound arguments have been made for using the indirect method and for using the direct method. For example, as noted by Bahnson et al., users of financial statements much prefer the direct method, whereas Anthony (1997) argued that the indirect method, by providing the reasons for differences between net income and the change in cash from operating activities, aids understanding of the cash tied up in or released from current assets and liabilities. If each method has valuable information content, why must corporations choose between them? A combination of the two methods, with emphasis on the clarity and understandability of the direct method, should provide transparency for cash flow reporting, provide valuable information for the reader, and help restore confidence in a battered financial accounting and reporting system. Therefore, I recommend that the FASB require the direct method and the associated reconciliation of net income to operating cash flow for the operating activities section of the statement of cash flows. In addition, the FASB should provide more guidance than it currently does on the classification of cash flows in the operating, investing, and financing sections of the statement. With better guidance, the opportunities for corporate officers to manage the content of the statement will be constrained. Also, independent auditors will be in a stronger position to prevent company managers from misclassifying specific cash flows to enhance cash flow from operations. I also recommend that the supplementary reconciliation should begin with cash flow from operations and proceed to net income, which is the reverse of the current practice in statements of cash flows. This recommendation has been made by others (Miller and Bahnson 2002), and it provides significant advantages for understanding operating cash flows. For example, the effects of operating cash flows not included in net income, such as prepayments for expenses and revenues collected in advance, can be shown as separate adjustments. Noncash revenues, such as uncollected sales on account, can be added, and noncash expenses, such as depreciation, can be subtracted. These adjustments are thus treated mathematically the same as they are in the income statement, with which the reader is doubtless familiar. Using the data from the previous examples of statements of cash flow in Tables 1 and 2, Table 3 illustrates the recommended format. The line-item descriptions have been changed to clarify that cash was received or paid for the items.

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In the reconciliation of net cash received from operating activities to net income, each adjust-ment would be reported in one of four categories, as Exhibit 1 shows. The first two categoriesoperating cash inflows not recognized as revenue and operating cash outflows not recognized as expense-remove the operating cash flows that were not reported in the income statement. The second two categories-revenues for which there were no current cash inflows and expenses for which there were no current cash outflows-add the amounts that were included in the income statement under accrual accounting but resulted in no cash flows this accounting period. This presentation provides a clear picture to the reader of the nature of these adjustments and how they reconcile operating cash flow to net income. Exhibit 1 illustrates how typical adjustments would be classified in one of the four sections. The adjustments listed are not intended to be an all-inclusive list but simply to give guidance on classification within the sections.

In addition to the change in format, the presentation in Table 3 uses clear, understandable terminology. For example, each line item in the direct presentation of operating cash flows is described as either "cash paid" or "cash received." In the absence of managerial intent to obfuscate and confuse, there is no excuse for using confusing terminology when straightforward descriptions can be better under-stood by the financial statement user. The users of financial statements deserve nothing less. Conclusion The 2001-02 corporate financial reporting debacles and the ensuing investor crisis of confidence in financial accounting and reporting validate the importance of financial reporting and emphasize the need for sound GAAP standards in the capital markets. They also heavily underscore the need to restore the credibility and reliability-both real and perceived-of financial accounting and reported information. Financial statements must not only be useful and fair; they must also have the trust and confidence of those for whom they are prepared.

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Because of the important role in the analytical process played by the statement of cash flows, it must be changed now. Fifteen years after the FASB recommended the direct method of reporting operating cash flows, the vast majority of corporations still use the indirect method. Now is the time to require the direct method because it provides a clearer, more easily understood picture of operating cash flows. Coupling the direct method with a more understandable reconciliation of cash flow from operations to net income will improve the information available for investors and creditors. The additional cost to corporations is a small price to pay for this more transparent reporting of corporate cash flows-and for the restoration of confidence in the financial reporting system. The author thanks the McIntire School of Commerce at the University of Virginia and the A.B. Freeman School of Business at Tulane University for their support in the preparation of this article. References References Anthony, Robert N. 1997. "Financial Reporting in the 1990s and Beyond." Accounting Horizons,vol. 11, no. 4 (December):107-111. Bahnson, Paul R., Paul B.W. Miller, and Bruce P. Budge. 1996. "Nonarticulation in Cash Flow Statements and Implications for Education, Research and Practice." Accounting Horizons, vol. 10, no. 4 (December):1-15. Day, Kathleen. 2002. "SEC Targets 'Swap' Deals by Telecom Firms." Washington Post (20 August):E1. FASB. 1987. Statement of Financial Accounting Standards No. 95, Statement of Cash Flows. Financial Accounting Standards Board (November). "Firm Acquired by Tyco Sped Payments to Bolster Cash Flow, E-Mail Indicates." 2002. Dow Jones Business News (18 March). Knutson, P. 1993. "Financial Reporting in the 1990s and Beyond." Charlottesville, VA: Association for Investment Management and Research, 1993 Position Paper. Maremont, Mark. 2002. "How Is Tyco Accounting for Its Cash Flow?" Wall Street Journal (5 March):C1-2. Miller, Paul B.W., and Paul R. Bahnson. 2002. "Fast Track to Direct Cash Flow Reporting." Strategic Finance, vol. 83, no. 8 (February):51-57. Sender, Henry. 2002. "Cash Flow? It Isn't Always What It Seems." Wall Street Journal (8 May):C1, C3. Solomon, Deborah. 2002. "Adelphia Overstated Cash Flow, Revenue over Past Two Years." Wall Street Journal (11 June):B5. White, Ben. 2002. "Tyco Report Paints Picture of Greed; Kozlowski Allegedly Decided Board." Washington Post (18 September):E1. AuthorAffiliation O. Whitfield Broome is Frank S. Kaulback, Jr. Professor of Commerce at the McIntire School of Commerce and professor of law at the School of Law at the University of Virginia, Charlottesville. Indexing (details) Subjects: FASB statements -- SFAS 95, Financial accounting standards, Cash flow, Financial analysis, Financial statements Locations: United States, US Classification: 4120: Accounting policies & procedures, 3400: Investment analysis & personal finance, 9190: United States Title: Statement of Cash Flows: Time for Change! Authors: O Whitfield Broome Publication title: Financial Analysts Journal Volume: 60 Issue: 2 Pages: 16-22 Number of pages: 7 Publication year: 2004

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Publication Date: Mar/Apr 2004 Year: 2004 Section: PERSPECTIVES Publisher: CFA Institute Place of Publication: Charlottesville Country of publication: United States Journal Subjects: Business And Economics--Investments, Business And Economics--Banking And Finance ISSN: 0015198X CODEN: FIAJA4 Source type: Scholarly Journals Language of Publication: English Document Type: Commentary Document Features: references;tables ProQuest Document ID: 219138136 Document URL: http://search.proquest.com.ezproxy.apollolibrary.com/docview/219138136? accountid=35812 Copyright: Copyright Association for Investment Management and Research Mar/Apr 2004 Last Updated: 2010-06-09 Database: 3 databases ProQuest Central ABI/INFORM Research ABI/INFORM Complete

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