

Cash Flow Accounting: Is it Time For Increased Disclosures?

Dr. John E. McEnroe, Amoco Professor of Accountancy, DePaul University, Chicago

Abstract

Cash flow reporting has attracted increased attention in the United States, especially in the past decade. However, despite the use of per share cash flow information by security analysts, the Financial Accounting Standards Board (FASB) has prohibited its disclosure. This article provides a historical perspective of cash flow accounting in the U.S., as well as a discussion of cash flow advocates. The final section presents arguments for increased disclosures in the area of cash flows, including operating cash flow on a per share basis and a schedule of free cash flows.

"Cash is the asset excellent."

William Paton, *Accounting Theory* (1922)

Introduction

At the end of 1984, Mesa Limited Partnership, T. Boone Pickens Jr.'s company, was rather eager to make an acquisition of a corporation from a list of candidates thought to be undervalued. Mesa had recently lost out to Chevron Corp. in its attempt to acquire Gulf Oil Corp. In describing the process by which he narrowed his potential targets, Pickens recalled, "We reviewed their balance sheets and reserves. Cash flow is the key." (Arndt, 1987, p. 1)

Corporate raiders such as Pickens, however, are not the only parties interested in cash flow information. This data may also be of use to shareholders, employees, creditors, and other accounting information users in their financial analysis needs. Accordingly, the purpose of this article is primarily two fold: 1) to provide the reader with a brief historical perspective of the development of cash flow accounting (CFA) in the U.S. as well as a discussion of cash flow advocates, and 2) to present arguments for allowing increased disclosures in the area.

Cash Flow Accounting in the U.S.

The concept of a funds statement has existed since the early 1900s in the United States. For example, in 1915, an academic, W.M. Cole, in his work *Accounts, Their Construction and Interpretation*, referred to a funds statement as a "Where-Got-Gone Statement." The usual title, however, was "Statement of sources and disposition of funds" although United States Steel Corp., in its early

financial reports, employed the more generic term "financial statement". (Hatfield, 1927, p. 460)

The term "cash flow" initially became popular in the 1950s in the United States, but was seldom found prior to that period. (Mason, 1961, p. 31) At about the same time though, the U.S. accounting profession attempted to downplay the role of cash flow information in published statements, fearing that it would be regarded as a superior, yet mendacious, measure of economic performance when compared to historical cost income. For example, in 1958, an editorial in the *Journal of Accountancy* expressed its concern over the growing interest that certain accounting information users had in "cash flow income."

We have been much disturbed by the increased use in recent years of the concept of cash earnings or cash flow earnings by the security analysts as an alleged improvement over the earnings or net income calculated in accordance with generally accepted accounting principles. (Blough, 1958, p. 77)

Consequently, an exposure draft of Accounting Principles Board Opinion No. 3 (APB 3) even recommended that the use of "cash flow" or any similar expression should be avoided in preparing the annual report of a corporation or other enterprise. The draft also stated, "Statistics of 'cash flow' or of 'cash flow per share' should not be presented." (Jaedicke and Sprouse, 1965, p. 125) Although the final Opinion deleted the recommenda

tion which would have prohibited the presentation of cash flow data, it said that if cash flow information is included, the data should be presented in a way that does not debilitate the significance of net income.

APB 19, the first promulgation to require a statement of changes in financial position, also strongly discouraged the disclosure of per share cash flow data. The SEC maintained a similar posture. For example, in a 1963 speech before businessmen, the SEC's Chief Accountant commented on the cash flow accounting issue, stating that the use of "cash flow" or similar terminology seems to suggest to the shareholder that his interest in the company should be evaluated in terms computed on a cash flow basis rather than in terms of earnings computed on a historical cost conventional basis. (Rappaport, 1972, p. 120) Accordingly, the SEC, through the issuance of Accounting Series Release No. 142 (ASR 142), also prohibited the disclosure of operating cash flow per share.

Although APB 19 permitted flexibility in the format of the statement of changes in financial position, allowing the concept of funds to be reported in terms of cash, cash and temporary investments combined, quick assets or working capital, in the 1980s the reporting trend accelerated towards a cash basis format. For example, a study conducted by Ernst and Whinney involving Fortune 500 companies revealed that in 1980, only about 10% of the firms used a cash basis approach funds-flow statement, while in 1985 this ratio increased to 72%. (Ernst and Whinney, 1986, p. 5)

In conjunction with this trend, the Financial Accounting Standards Board (FASB) had been formally studying the reporting of CFA since 1980. The Board concluded in Statements of Financial Concepts Nos. 1 and 5 that information involving cash receipts and payments is important to accounting information users, and subsequently issued Statement of Financial Accounting Standard No. 95 (FAS 95), *Statement of Cash Flows*, in November, 1987, superseding APB 19. This extant pronouncement requires a statement of cash flows in lieu of the options previously allowed under APB 19. FAS 95 also requires an "operating, investing, and financing activities" (cash inflow/outflow) classification instead of the previous "sources and uses" of funds format. The 1985 Ernst and Whinney study indicated that approximately 50% of the surveyed companies had been using the latter approach. As in the earlier reporting requirements, the presentation of cash flow per share is prohibited by FAS 95.

The issuance of FAS 95 was not free of controversy, however, and was passed by a rather contentious vote of only 4-3. In fact, had the "supermajority" rule imple-

mented in January, 1991 been in effect, requiring a vote of at least 5-2 to pass a Financial Accounting Standard, the Statement would probably not have been issued in its present form. Some of the reasons cited by the three dissenters for casting their negative votes involved the classification of interest, dividends, and certain other cash receipts and payments. Two of these individuals also protested the permitted use of the indirect method of reporting cash flow from operating activities.

Cash Flow Advocates

Many CFA proponents argue that much of its relevance is engendered by the latitude awarded to reporting entities in their arbitrary use of cost allocations. Arthur Thomas, who has written extensively in the area of CFA, argues that such allocations are "incurable" in the philosophical definition of an assertion that is impossible to verify or falsify. Thus, he and others argue that such adjustments as the addition of noncash expenses is necessary before the economic performance of an entity can be measured. (Thomas, 1969)

Security analysts have extracted cash flow data in their analysis for some time now, even calculating the statistic "cash flow per share" as in the *Value Line* stock investment reports. It was exactly this type of use of CFA information that caused the concern in the previously cited *Journal of Accountancy* excerpt which was written over thirty-five years ago. William Paton also lamented the increased use of cash flow analysis on the part of security analysts, whom he perceived to be embracing an ersatz income measure (Paton, 1963, p. 243):

Security analysts, not always noted for their grasp of accounting principles and procedures, seem to be suffering from an acute case of 'cash flowitis' manifested especially by their fondness for per share calculations of cash flow in company with or superseding earnings per share.

Despite such criticism, CFA has remained an integral part of the financial analysis process of professional security analysts and money managers. For example, one U.S. money management team (Melvin Turkman and Daniel Grossman), whose portfolio ranked them first among 474 managers in 1990 and first among 261 managers for the five years through 1990 (according to CDA Investment Technologies) stated that a stock must have large "free cash flow" (defined in an ensuing section) as a necessary condition of its acquisition. (Dorfman, 1991, p. C2) Another example of CFA analysis occurred in a report appearing in *Value Line*, the popular investment advisory publication. Referring to the takeover of the fast food company, Jerrico, Inc., the analysis made no mention

of price earnings multiples influencing the acquisition price. Rather, the report stated (Openshaw, 1989, p. 306):

Still, Jerrico's selling price amounted to only 6.9 times estimated fiscal 1989 (ended June 30th) pretax cash flow. Although this is near the low end of the range of recent takeover values in this industry, there were no competing bids-nor did we really expect any.

Thus, in this latter case, cash flow rather than net income was regarded as the key measure in evaluating the likelihood of a takeover. There is even a recently published 288 page book that focuses on CFA titled *Cash Flow and Security Analysis* (Hackel and Livnat, 1992) which, among other advertised qualities, lists: "Proven methods for identifying undervalued companies and takeover targets," and "Dozens of examples of companies whose stock increased dramatically after their free cash flow was determined." (Wall Street Journal, September 28, 1992, p. A7)

However, this affinity for cash information may extend to other accounting information users besides security analysts. For example, consider the following published comment by a Big Six audit partner regarding how he analyzes an annual report (Leckey, 1991, p. 3):

"I always go backwards through a report, reading the statement of cash flows first, for it's the most important part of an annual report because it is really the measure of business success. Next, I'd look at the income statement, followed by the chairman's letter and narrative in the front."

Lastly, a group of academics (Previts et al. 1994) conducted a study of 479 financial analyst reports found, on average, cash flow phrases occur about 7.5 times per report and that many analysts produce Non GAAP cash flow schedules, including those depicting discretionary or free cash flow. They also found cash flow per share or operating cash flow per share in one third of the reports. Other cash flow per share statistics included such terms as "fully diluted", "distributable", "discretionary", and "free".

Recommended Cash Flow Disclosures

Given this background, the two additional cash flow disclosures that I propose to include in annual reports are: 1) cash flow from operating activities on a per share basis, and 2) a statement of "free cash flows" (cash flow from operating activities less capital expenditures and dividends). I would recommend that this latter figure also be permitted to be shown on a per share basis, if so desired.

Operating Cash Flow Per Share

First, in respect to the presentation of operating cash flow on a per share basis, it should be recognized that the statistic has for sometime now been widely used in investment analysis, and will probably continue to be regarded as a valuable financial measure. Both *Standards and Poor's Stock Reports* and *Value Line* present this per share figure or a slight variation thereof. Another manifestation of its mainstream citation is its frequent mention in the "Heard on the Street" analysis, the *Wall Street Journal's* stock advisory column. Recently, two consecutive columns (Wall Street Journal, 1994) made reference to operating cash flow per share, one in relation to real estate investment trusts, and the other in regard to a restaurant holding company. The question then follows as to why, for each of their common stock investments, stockholders have to resort to commercial investment services to obtain the figure, since it has proven to be a perdurable number in security analysis.

In its "Basis for Conclusions" section contained in the appendix of FAS 95, the FASB attempted to justify the prohibition by averring that per share disclosure "would falsely imply that cash flow, or some component of it, is a possible alternative to earnings per share as a measure of performance." (FASB, 1987, par. 122) The Board had made essentially the same statement earlier in the body of the Standard. However, no empirical or even anecdotal evidence was provided for its admonishments regarding the purported confusion such disclosures might create for "investors, creditors, and others...".

Furthermore, the Board stated that the majority of the respondents to the Exposure Draft *who addressed the issue* (emphasis added) agreed that cash flow per share should not be reported. The problem with this argument is that it does not represent a scientific sample of accounting information users. Despite this argument on the part of the FASB for selected CFA censorship, various users might very well be fully cognizant of the nature of this cash flow measure and may desire per share operating cash flow as an indicator of ability to fund common stock dividends, or for other indications of financial strength.

As to any misunderstanding, the statistic might precipitate, consider the explanation that *Value Line* provides for the cash flow per share figure it provides: "It is an indication of a company's cash generating ability - the amount of cash it earns to expand or replace plant and equipment, to provide working capital and to pay dividends". Thus this definition belies the notion of a misconception of the nature of the statistic. Lastly, the cash flow standards of most other countries do not prohibit disclosure of per share cash statistics.

Free Cash Flows

The notion of “free cash flows” has become popular within the last ten years largely due to Jensen (1986). He developed a theory involving free cash flows that asserts that conflicts exist between stockholders and corporate managers over free cash flow distributions. Managers, Jensen states, attempt to retain cash and allow a company to grow beyond its optimal size due to such reasons as increasing management power and compensation, while stockbrokers, on the other hand, largely desire dividends. Jensen further states that free cash flow distributions also impact a firm’s security prices. Lang and Litzenberger (1989) found that, consistent with Jensen’s free cash flow theory, firms categorized as over investors had statistically significantly higher security returns associated with announcements of dividend increases than for value maximizing firms. The larger market reactions to the latter category is presumably evidence that the firms are addressing the problem described by Jensen by reducing the cash available to management. Furthermore, in an investigation of publicly traded firms that went private, Lehn and Poulsen (1989) found a significant relationship between undistributed free cash flow and the probability of going private, and that the premiums paid to shareholders in these events are positively and significantly related to free cash flow. Although these have been academic studies, the concept of free cash flows, (as evidenced by the examples cited previously) is now also widely used in everyday investment analysis, as a measure of discretionary cash. Furthermore, the references to this cash measure in common stock evaluations is becoming very frequent. Besides its value in the previously mentioned studies, it is also an indication of the ability to fund treasury stock purchases and increase earnings per share. As a result, I recommend that a schedule of its components also be included in a firm’s annual report.

If these two disclosures were permitted, the logical location would be on the same page as the Statement of Cash Flows, probably in a section titled “Supplementary Cash Statistics”.

Conclusions

I hope that this discussion of CFA has proven to be of interest and might engender further dialogue on the issue. The U.S. has been the world leader in the area of financial reporting both in the quality of disclosure and innovation. The presentation of these cash measures would further demonstrate that leadership.

Suggestions For Further Research

A survey of accounting information users, including financial analysts, creditors, shareholders, and others is appropriate in order to determine if they favor disclosure of operating cash flow per share and free cash flows in the annual reports of U.S. entities. The survey might also poll them as to what other cash flow accounting information they might desire that is not currently being provided. Such research is necessary, for only by identifying the needs of accounting information users will the FASB and other standard setting-setting bodies be able to provide them with relevant accounting information. 📖

***** References *****

1. Arndt M., “Raiders Leave Mark on Phillips’ Town,” *Chicago Tribune* (September 22, 1987)Section 3, pp. 1-3.
2. Blough, C.G., “Cash Flow Earnings--A Dangerous Concept,” *Journal of Accountancy* (October, 1958) pp. 77-78.
3. Dorfman, J.R., “Turkman Investment Stays Ahead of the Pack, Picking Stocks in Simple, Old Fashioned Way,” *Wall Street Journal* February 14, 1991) p. C2.
4. Ernst and Whinney, “Statement of Cash Flows,” *Financial Reporting Developments* (October, 1986) pp. 1-20.
5. Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 95 Statement of Cash Flows* (Stamford: FASB, 1987).
6. Hackel, K. and J. Livnat, *Cash Flow and Security Analysis* (Homewood, Illinois: Business One Irwin, 1992.)
7. Hatfield, H.R., *Accounting* (D. Appleton and Co., 1927, reprinted by Scholars Book Co., Houston, Texas, 1971).
8. Jaedicke, R.K., and R.T. Sprouse, *Accounting Flows: Income, Funds and Cash* (Englewood Cliffs,N.J.: Prentice-Hall, 1965).
9. Jensen, M., “Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers,” *American Economic Review* (May, 1986) pp. 323-328.
10. Lang, L. and R. Litzenberger, “Dividend Announcements: Cash Flow Signalling vs. Cash Flow Hypothesis?” *Journal of Finance* (September, 1989) pp. 455-477.
11. Leckey, A., “Style vs. Substance in Annual Reports,” *Chicago Tribune* (May, 1991) Section 3, p. 3.
12. Lehn, K. and A. Poulsen, “Free Cash Flow and Stockholder Gains in Going Private Transactions,” *Journal of Finance* (July, 1989) pp. 771-787.

13. Mason, P., *Accounting Research Study Number Two, 'Cash Flow' Analysis and the Funds Statement*, (AICPA, 1961).
14. Openshaw, H., "Jerrico, Inc." *Value Line* (September 29, 1989) p. 306.
15. Paton, W.A., *Accounting Theory* (1922, reprinted by Scholars Book Co., Houston, Texas, 1973).
16. Paton, W.A., "The Cash Flow Illusion," *Accounting Review* (April, 1963) pp. 243-251.
17. Previts, G., R. Bricker, T. Robinson, and S. Young, "A Content Analysis of Sell Side Financial Analyst Company Reports," *Accounting Horizons* (June, 1994) pp. 55-70.
18. Rappaport, L.H., *SEC Accounting Practice and Procedure* (New York: Ronald Press, 1972).
19. Thomas A.C., *Studies in Accounting Research #3: The Allocation Problem* (Evanston, Illinois: American Accounting Association, 1969).
20. *Wall Street Journal*, "Find Tomorrow's Top Stocks Today," (Advertisement, September 28, 1992)p. A7.
21. *Wall Street Journal*, Friday, December 16, 1994, p. C2 and Monday, December 19, 1994, p. C2.