

# CASH FLOW STATEMENTS

## Is there room for improvement?

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**The issue of a Statement on Cash Flow Information (AC 118)<sup>1</sup> has generally been welcomed and has contributed to improved reporting standards. However, certain problem areas still exist and need to be addressed in the near future. This article discusses some aspects that require clarification, that have not been addressed or that may require reconsideration.**

A cash flow statement drafted on the pure cash flow approach only includes transactions that affect cash. In contrast, the all financial resources approach includes all significant financial transactions, irrespective of whether they affect cash or not.

AC 118 adopts the all financial resources approach, which is also followed by most listed companies in South Africa. This approach has in recent years been severely criticized,<sup>2</sup> especially when used in conjunction with cash flow information. The inclusion of any non-cash transactions in a cash flow statement can be misleading, as both the actual cash receipts and the actual cash payments will be overstated.

If non-cash transactions are significant, relevant and not readily available from the other financial statements, such information should rather be included in a note to the statement. The Financial Accounting Standards Board has supported this opinion in its Statement on Cash Flow Information (SFAS 95),<sup>3</sup> concluding that the inclusion of non-cash transactions would unduly complicate the cash flow statement and detract from its primary objective of providing information about the cash receipts and payments of an enterprise during a period.

I suggest that this approach should be followed even where a transaction is partly cash and partly non-cash, in which event only the cash portion is reported on the statement of cash flows and the non-cash portion is disclosed in a separate note or schedule to the statement.

So it is my view that AC 118 should adopt the pure cash flow approach rather than the all financial resources approach.

The cash flow from operations may be calculated using either the direct or the indirect method. In *A Survey of Financial Reporting in South Africa* issued by the South African Institute of Chartered Accountants,<sup>4</sup> the direct method is defined as reporting gross amounts of cash receipts and cash payments during a period. This is in contrast to the indirect method, which reports net cash generated by operations, which is normally calculated by adjusting operating income before tax for items which do not involve the movement of cash.

AC 118<sup>5</sup> adopts the indirect method of calculating the cash flow from operations. This approach conflicts with the general guideline in the statement<sup>6</sup> of disclosing gross rather than net flows of cash to reduce the potential for losing important information. The specific exclusion of operating cash flows from this general guideline, however, suggests that the additional information disclosed by the direct method is not considered relevant or useful to the user of financial statements.

As strong support exists for both methods, it is interesting to note that the Financial Accounting Standards Board has allowed both methods in its Statement,<sup>7</sup> but has specifically encouraged enterprises to use the direct method.

In support of the direct method Lauver and Swieringa, in their dissenting votes to SFAS

<sup>1</sup> South African Institute of Chartered Accountants, Accounting Practices Board (APB) 'Cash Flow Information', (AC 118) 1988.

<sup>2</sup> D E Giacomino & D E Mielke 'Preparation and Use of Cash Flow Statements' *CPA Journal* March 1987 30-5, S J Golub & H D Huffman 'Cash Flow — Why It should be Stressed in Financial Reporting' *Financial Executive* February 1984 34-40, G K Everingham & B D Hopkins *Generally Accepted Accounting Practice* 2 ed 11th update (1988).

<sup>3</sup> Financial Accounting Standards Board (FASB) 'Statement of Cash Flows', Statement of Financial Accounting Standards 95 (SFAS 95) 1987.

<sup>4</sup> (1988) 8-10.

<sup>5</sup> APB op cit (note 1 above) para 17.

<sup>6</sup> APB op cit (note 1 above) para 8.

<sup>7</sup> FASB op cit (note 3 above).

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95, stated that the information disclosed by the direct method provides a description of the operating activities that is both more informative and more consistent with the primary purpose of a statement of cash flows, and concluded that the indirect method should not be permitted.

The indirect method is, however, supported by several authors.<sup>8</sup> The main advantage of the indirect method is that it provides a link between net income and the cash flow from operations, highlighting those revenues and expenses which are said to affect the 'quality' of income.

As opinions are divided on the relative merits of each method, the solution may be to allow both methods. AC 118<sup>9</sup> states specifically that the format and presentation of a statement of cash flow information will depend on the particular circumstances of the enterprise. Hence the method adopted in calculating net cash from operations should also depend on the particular circumstances of an enterprise, and management should decide what method will provide users with the most relevant information.

If an enterprise uses the direct method it may be advisable to follow the example of Adcock-Ingram in its 1988 financial statements by including a reconciliation between net income and net cash generated from operations as a note to the cash flow statement.

Two theories have evolved on the treatment of minority interests in consolidated financial statements. The parent company theory<sup>10</sup> assumes that the reporting entity does not change as a result of the consolidation process. The parent company is still considered the reporting entity, and as a result the interest in the minority shareholders is not considered an equity interest in the consolidated reporting entity. In contrast, the entity theory assumes that the reporting entity has changed as a result of the consolidation process and a new reporting entity is deemed to exist. As a result the parent company shareholders and minority interests are both treated as the equity interest of the consolidated reporting entity.

AC 118 implicitly adopts the entity theory, as the objective of the consolidated cash flow statement is to provide information relating to flows of cash and not ownership interests.<sup>11</sup> However, the entity theory has not been applied consistently throughout the statement. The statement follows the parent company theory in recommending that the acquisition and disposal of subsidiaries should be shown as a single-line item in the consolidated cash flow statement, with separate notes providing details of the assets and liabilities. According to the entity theory, the movement of the individual assets and liabilities of these subsidiaries should be disclosed in the cash flow statements.<sup>12</sup>

AC 118 concentrates on the information to be reported in the cash flow statement. The statement only reflects the historical situation, however, whereas cash flow accounting is mainly concerned with forecasting the future.

Although it is generally accepted that the cash flow statement should not be used in isolation to project future cash flows, the relevant information may not be readily available in the rest of the financial statements. In this regard Golub and Huffman<sup>13</sup> give examples of additional information that may assist users in understanding and projecting the cash flow statement.

These include

- material, unusual or infrequent operating cash flows;
- reasons for and implications of significant increases or decreases in cash flows;
- the extent to which the current operating cash flow is indicative of the future;
- available unused sources of financing;
- planned additional investments;
- the extent to which current and planned expenditures are discretionary;
- the purposes of current and planned financing activities;
- anticipated needs for future financing.

Therefore management should provide more commentary on the results of the historical cash flow statement, and should include more useful information on the potential future cash flows.

After all, the purpose of financial reporting is to provide information that is helpful in assessing the amounts, timing and *uncertainty* of the *prospective* cash flows of an enterprise.<sup>14</sup>

The Accounting Practices Committee may assist management in its task by identifying the type of information that should be disclosed with a cash flow statement. This may be achieved by adding an appendix to AC 118 or by issuing a guideline.

<sup>8</sup> E P Swanson 'Designing a Cash Flow Statement' *CPA Journal* January 1986 38-45, J J Mahoney, M V Sever & J A Theis 'Cash Flow: FASB Opens the Floodgates' *Journal of Accountancy* May 1988 27-38, G K Everingham & B D Hopkins *Seminar on Current Issues in Financial Reporting* 1988.

<sup>9</sup> APB op cit (note 1 above) para 10.

<sup>10</sup> A J Pahler & J E Mori *Advanced Accounting: Concepts and Practice* 2 ed (1985) 160-2.

<sup>11</sup> APB op cit (note 1 above) para 37.

<sup>12</sup> N G J Troost 'Objectives and Format Guidelines for Cash-based Funds Statements' (unpublished MCom thesis) 1986.

<sup>13</sup> Loc cit (note 2 above).

<sup>14</sup> Financial Accounting Standards Board (FASB) 'Objectives of Financial Reporting', *Statement of Financial Accounting Concepts* 1 (SFAC 1) 1978.