HISTORY OF THE CASH FLOW STATEMENT

The balance sheet and income statement have been required statements for years, but the cash flow statement has been formally required in the United States only since 1988. However, cash flow statements, in some form or another, have a long history in the United States. In 1863, Northern Central Railroad issued a summary of its financial transactions that included an outline of its cash receipts and cash disbursements for the year.

Because current assets can be thought of as those assets that are close to becoming cash and current liabilities as those liabilities that are close to being paid in cash, an alternative to focusing on cash flow is to examine the net change in working capital (current assets minus current liabilities). In some sense, working capital is equal to cash plus net short-term potential cash. In 1902, United States Steel Corporation produced a report that listed the major causes of the change in “funds” during the year, with *funds* being defined as current assets minus accounts payable. A working capital funds statement became increasingly popular after 1920.

In 1971, the APB issued *Opinion No. 19* officially requiring that a funds statement be included as one of the three primary financial statements in annual reports to shareholders and that it be covered by the auditor’s report. *Opinion No. 19* did not specify a single definition or concept of funds or a required format for the statement. This statement was called the *statement of changes in financial position*. During the 1970s, the statement of changes in financial position (or funds statement) was not given great emphasis and was usually not even discussed in introductory financial accounting courses.

During the early 1980s, the Financial Executives Institute (FEI) encouraged its members to adopt a cash emphasis in their statements of changes in financial position. In 1980, only 10% of the Fortune 500 companies used a cash focus; the other 90% reported net changes in working capital. By 1985, 70% used a cash focus. During this same period, the FASB issued *Statement of Financial Accounting Concepts No. 5*, which suggested that, conceptually, a cash flow statement should be part of a full set of financial statements. In late 1987, the FASB issued *Statement No. 95*, which superseded APB *Opinion No. 19*. Instead of allowing various definitions of funds, such as cash or working capital, and a variety of formats, the FASB called for a statement of cash flows to replace the more general statement of changes in financial position.

Because the required cash flow statement is relatively young (remember, double-entry accounting is 500 years old), it sometimes doesn’t get the emphasis it deserves as one of the three primary financial statements. Many accounting textbooks still delay coverage of the cash flow statement until the end of the book. In addition, most of the age-old tools of financial statement analysis do not incorporate use of cash flow data. In fact, because the traditional analysis models were developed in an age when cash flow data were not available, analysts will go to great lengths to approximate cash flow numbers, seemingly unaware that since 1988 the actual numbers have been easily available in the cash flow statement. For example, a number often used in evaluating a company’s health is earnings before interest, taxes, depreciation, and amortization (EBITDA). When pressed about the reason for using this number, an analyst will say, “EBITDA approximates operating cash flow.” Why don’t analysts use the real cash flow numbers? Because information from the cash flow statement is not yet ingrained in the analytical tradition—but it will be. In fact, one way to impress others that you are a modern, well-trained, future-looking professional is to become proficient in preparing and analyzing cash flow statements.

Questions:

1. Which do you think is more important, the income statement or the statement of cash flows?

Source:

James H. Thompson and Thomas E. Buttross, "Return to Cash Flow," *The CPA Journal*, March 1988, pp. 30–40.

BACKGROUND OF FASB *STATEMENT NO. 95*

The FASB cash flow pronouncement, *Statement No. 95,* illustrates that the setting of accounting standards is not a science but is a "balancing act" with the differing opinions of users and preparers being weighed against one another and the considerations of cost of implementation being weighed against the potential benefits. Because standard setting is a balancing act, not all interested parties will agree on the final outcome. In fact, three of the seven FASB members dissented to the final version of *Statement No. 95*. One area of disagreement involved the categorization of interest and dividend cash flows. Three of the Board members believed that interest and dividends paid are a cost of obtaining financing and each should be classified as a cash outflow from financing activities. In *Statement No. 95*, however, dividend payments are included in the Financing Activities section while interest payments are classified as cash outflows from operating activities. Similarly, the three Board members believed that interest and dividends received are returns on investments and therefore should be classified as cash inflows from investing activities. *Statement No. 95* includes both items in the Operating Activities section.

A more significant disagreement related to the permissibility of both the indirect and the direct methods of reporting cash flow from operations. Before the issuance of the statement, a majority of the outside comments to the Board advocated requiring use of the direct method. Most of these comments were from commercial lenders who indicated that detailed cash flow information by category would help them to better assess a firm's ability to repay borrowing. Those opposed to this direct method requirement and who instead advocated the permissibility of both methods were mainly preparers and providers of financial statements. They argued that requiring the use of the direct method would impose excessive implementation costs on some firms. They also argued that the indirect method provides more meaningful information because it is more similar to what has been used in the past. *Statement No. 95* allows both methods but does "encourage" use of the direct method.

The statement also describes major change in financial reporting as "an evolutionary process." Conceptual purity is balanced against feasibility and cost of implementation. While it is likely that the standards of cash flow reporting will be further improved in the future, *Statement No. 95* represents a significant incremental improvement over prior practice.

Questions:

1. Interest and dividends paid are both costs of obtaining financing: Interest is the cost of obtaining debt financing, and dividends are the cost of obtaining equity financing. Accordingly, some have advocated classifying both interest and dividends paid as cash outflows from financing activities. What arguments can

you think of to support classifying interest paid as an operating cash outflow as required by *Statement No. 95*?

2. Assume that you are a member of the FASB and that the Board is reconsidering the issue of whether both the direct and indirect methods should be allowed. What evidence would you look at to help you make your decision?

Sources:

Dennis R. Beresford, “The ‘Balancing Act’ in Setting Accounting Standards,” *Accounting Horizons*, March 1988, pp. 1–7.

Statement of Financial Accounting Standards No. 95, “Statement of Cash Flows” (Stamford, CT: Financial Accounting Standards Board, November 1987), pars. 88–90 and 106–121.