OPINION

Making Stronger Statements: *Cash Flow and Income*

By Bruce Wampler, CPA; Harold C. (Carl) Smolinski; and Timothy Vines

Statement of Financial Accounting Concepts (SFAC) No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," states that a full set of financial statements should include, among other things, information about an entity's cash flows and net income. The interrelationship between them is obvious: Cash flow information is necessary to both substantiate and complement reported income. Furthermore, cash flow information is an important factor in investment decisions, firm valuation, and performance appraisal. Consequently, in 1987 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 95, "Statement of Cash Flows," which requires that an SCF be included for each period for which the results of operations are provided. This Standard has since been incorporated into the FASB's 2009 *Accounting Standards Codification*™.

SFAS No. 95 requires that cash flows be shown in one of three categories: operating, investing, and financing. Although there was broad support for the use of these three categories, there was significant disagreement concerning how to classify certain cash flows within them. For example, many respondents to the Exposure Draft (and three of the seven FASB members) believed that cash flows for interest should *not* be classified as operating activities. There was also disagreement regarding the presentation method (direct or indirect) for operating cash flows. Although SFAS No. 95 permits the use of either method, two FASB members felt that the indirect method should be prohibited. Thus, despite the widespread support for an SCF, disagreements over format, presentation, and classification were so significant that the final Statement was adopted by a slim margin of 4 to 3.

To help sort through these issues, the FASB is currently engaged in a joint project with the International Accounting Standards Board (IASB). Phase B of this project specifically mentions consideration of SFAS No. 95 and International Accounting Standard (IAS) No. 7, "Cash Flow Statements," including whether to require the use of the direct or indirect method. The Boards also have agreed to take a fresh look at the presentation of information in the financial statements, which implies that more fundamental changes to both the SCF and the income statement might be considered.

Because it has been more than 20 years since SFAS No. 95 was issued, it's time to revisit the design of the SCF and the manner in which cash flows are classified. Our approach addresses several classification issues associated with the current format and provides cash flow information that more closely correlates with what is (or should be) provided on the income statement, especially with regard to operating income. We believe it results in a more useful financial statement.

A Consistent Approach

SFAS No. 95 lists several specific objectives that an SCF (along with related disclosures and information in other financial statements) should satisfy if it's to be as beneficial as possible. One of these objectives is to provide information to help management accountants and other users "assess the reasons for the differences between net income and associated cash receipts and payments." Our approach makes it easier to evaluate the reasons for these differences, especially differences between operating income and cash flows from operating activities.

The fundamental conflict between cash-basis and accrual-basis accounting arises because of the need for periodic financial statements (i.e., the time-period assumption), which tie revenues and expenses with specific accounting periods. For accrual-basis accounting, the resulting recognition issues are sometimes subjective, whereas these issues never arise under cash-basis accounting since cash receipts and payments are simply recognized in the period in which they occur. In the long run, total income must be equal under both bases of accounting: In other words, if financial statements were prepared only at the end of an entity's life, the choice of accounting method would be irrelevant.

Most accountants (including us) would agree that accrual-basis operating income provides more relevant information regarding a company's performance than cash-basis operating income. Yet some question the reliability of the income statement because of the many estimates involved in determining accrual-basis operating income. Although the income statement should remain the primary statement used to evaluate performance, the SCF nevertheless provides supplemental information that many accountants find invaluable. As noted in SFAC No. 5, an SCF "provides useful information about an entity's activities in generating cash through operations to repay debt, distribute dividends, or reinvest to maintain or expand operating capacity."

The basic premise of our approach is that operating cash flows should reflect the current-period cash effects of those items included in calculating operating income for the same period. The operating section of the SCF should provide a cash-basis measure of the company's performance in much the same way that operating income from the income statement provides an accrual-basis measure. With this objective in mind, we can look to the income statement to help answer some of the classification and presentation issues associated with the SCF, particularly in regard to the operating section. It may not be necessary to address a particular issue involving operating cash flows if the same question has already been debated and resolved with respect to the income statement. The cash effects of any item that isn't part of operating income would be shown in either the investing or the financing section of the SCF.

Direct vs. Indirect

Our approach to preparing the SCF is logically consistent with the income statement, but we prefer the direct method and would eliminate the indirect method as an alternative. The operating section of the SCF should show the same level of detail as the income statement. For example, if an expense or revenue is significant enough to be shown as a separate line item on the income statement, its cash effects (if applicable) should be shown as a separate line item on the SCF. Thus, the operating section of the SCF won't follow a strict format but will be (in most cases) modeled after each company's income statement.

Although a subtotal for operating cash flows is mandated, companies currently have significant flexibility with regard to income statement format (single-step or multiple-step, for example) and aren't required to display a subtotal for operating income. Since net income is probably the most quoted measure of enterprise performance, it's somewhat surprising that the FASB pronouncements are more rigid with respect to cash flows than income. This may be because the FASB has often been flexible on matters of display or simply because it's easier to prescribe the format for a new financial statement than to change the manner in which the old ones are presented.

Nevertheless, from the time of the controversy between the current operating performance and the all-inclusive approach to determining income, the importance of operating income has been recognized. As noted in SFAC No. 5, "... because income statements also are used as a basis for estimating future performance and assessing future cash flow prospects, arguments have been advanced urging exclusion of unusual or nonrecurring gains and losses that might reduce the usefulness of an income statement for any one year for predictive purposes." It's apparent that financial reporting would be improved if all companies were required to provide a subtotal for operating income on the face of the income statement as it displays the entity's performance in its ordinary, recurring operations.

The multiple-step format provides more information about the components of income—such as gross profit, other revenues and gains, and other expenses and losses—than the single-step format. Because of this, we hope that the FASB will consider eliminating the single-step method and begin requiring all businesses to report income using the multiple-step format, with a subtotal for operating income. Even if the FASB elects *not* to require companies to report operating income separately, they should still have to include those items that are conceptually a part of their operating income in the operating section of the SCF. In these situations, the value of the financial statements may be somewhat diminished since their inconsistencies in format will hinder direct comparisons between the two statements.

An Example

To facilitate discussion of our approach and compare it to the current SCF format, we use a simple example that contains some of the most common items included in an SCF. Tables 1 and 2 show comparative balance sheets (for 2009 and 2008) and a 2009 income statement for a hypothetical company.

A review of the income statement reveals information that should be used in designing the SCF. We'll now discuss the major inconsistencies between the income statement format and the format of the SCF as specified by SFAS No. 95 along with our suggestions for revising the SCF.

Interest received. Because interest revenue isn't included in operating income, cash interest received shouldn't be included in operating cash flows. We place cash interest received in the investing section of the SCF since it arises from investments. Note that the classification of specific items may vary across industries as is sometimes the case even under current standards. For example, a bank would consider cash interest received as

Table 1: BALANCE SHEETS

	12/31/09	12/31/08	CHANGE
Cash	$ 33,000	$ 15,000	+18,000
Accounts receivable	80,000	50,000	+30,000
Inventories	50,000	75,000	−25,000
Prepaid rent	10,000	5,000	+5,000
Interest receivable	-0-	1,000	−1,000
Investment in bonds (HTM)	-0-	24,000	−24,000
Equipment	260,000	200,000	+60,000
Accumulated depreciation	−65,000	−40,000	+25,000
Intangible assets	18,000	20,000	−2,000
Total assets	**$386,000**	**$350,000**	
Accounts payable	20,000	35,000	−15,000
Wages payable	15,000	12,000	+3,000
Interest payable	3,000	7,000	−4,000
Income tax payable	2,000	6,000	−4,000
Note payable	30,000	80,000	−50,000
Common stock (no par)	200,000	100,000	+100,000
Retained earnings	116,000	110,000	+6,000
Total liabilities and stockholder equity	**$386,000**	**$350,000**	

part of operating cash flows since interest revenue is included in operating income on its income statement.

Interest paid. Interest expense isn't deducted in calculating operating income. The reason for this is that it allows a company's operating performance to be isolated from the effects of its choice of capital structure (i.e., the relative mix of debt and equity). Therefore, the company's performance can be analyzed relative to that of other companies with different capital structures. For the same reason, cash paid for interest should be excluded from operating cash flows. Our approach considers cash paid for interest as a financing outflow since it relates to a financing activity.

Purchase of operating assets. Because depreciation is shown as an operating expense on the income statement, its cash-basis equivalent should appear in the operating section in the SCF. This means that cash paid for operating assets, which is the best cash-basis proxy for depreciation expense, should be shown as an operating outflow in the SCF. Although this treatment is a significant departure from the current practice of including these items in the investing section, it's consistent with the income statement and reflects the fact that new assets are necessary to maintain or increase operating cash flows.

Some may criticize this approach because it allows the operating section of the SCF to be manipulated (by managing the timing of cash payments) and may result in volatile operating cash flows across periods. Furthermore, this method fails to recognize the future benefit of payments for assets with long useful lives. While these are valid criticisms, these deficiencies are inherent in cash-basis accounting and are the very ones that we attempt to rectify by using accrual-basis accounting. The SCF shows historical cash flows in the period in which they occur and may be a poor predictor of future cash flows, espe-

Table 2: 2009 INCOME STATEMENT

Sales revenue		$550,000
Cost of sales		325,000
Gross margin		225,000
Operating expenses		
Rent	60,000	
Wages	100,000	
Depreciation	30,000	
Amortization	2,000	192,000
Operating income		33,000
Other revenues and expenses		
Interest revenue	1,000	
Gain on sale of investment	6,000	
Interest expense	−8,000	
Loss on sale of equipment	−2,000	−3,000
Income before income taxes		30,000
Income tax expense (30%)		9,000
Net income		**$21,000**

Additional information:

- Bonds held as an investment (classified as held-to-maturity) and carried at their cost of $24,000 were sold for $30,000, generating a $6,000 gain.
- New equipment was purchased for $75,000 cash. Old equipment, with a cost of $15,000 and accumulated depreciation of $5,000, was sold for $8,000 cash, resulting in a $2,000 loss.
- No intangible assets were purchased or sold during the year.
- Cash of $50,000 was used to liquidate a portion of the note payable. No new borrowings occurred during the year.
- Common stock was issued for $100,000 cash.
- Cash dividends of $15,000 were paid to shareholders.

cially discretionary ones.

You may be further questioning this approach because you're accustomed to capitalizing fixed assets, which are essentially long-term prepaid expenses. Yet there's no such thing as a prepaid expense under strict cash-basis accounting; any cost that ultimately will be consumed in operating the business must be expensed in the period of the cash outlay. Comparative cash flow statements (preferably for at least three years) should allow management accountants to determine whether or not the current-year cash flows represent a "typical" year and help them better predict future cash flows.

Disposition of operating assets. On the income statement, these gains and losses are excluded from operating income. The logic behind this is that sales of operating assets aren't part of the company's principal operations but are simply a secondary activity that occurs periodically. These gains/losses really arise because the company previously took too much (or too little) depreciation relative to the change in the asset's fair value over time. You could argue that these gains and losses are similar to a change in estimate that becomes evident only upon disposition and should flow through current-period depreciation expense as part of operating income. For this reason, and to be consistent with our treatment of purchases of operating assets (which are operating outflows), we show the cash proceeds from sales of these assets in the operating section. Although our treatment differs from the income statement treatment, we believe this method is justified. Purchases and sales should be shown separately since information could be lost if the numbers are netted.

For consistency, cash flows for all operating assets—including those not subject to depreciation or amortization (land, trademarks, and so forth)—should be displayed in the operating section. Although it's possible that the cost of such assets will never be expensed, they're subject to review for impairment, which may result in a charge to income. Unfortunately, the cash outflow must be classified on the SCF at the time the asset is acquired, without knowing whether a future impairment loss will be recognized. Furthermore, even if these assets weren't subject to review for impairment, they're operating assets, and cash flows for operating assets should be shown in the operating section (cash flows for nonoperating assets, such as land held as an investment, would continue to be shown in the investing section). When and if the assets are disposed of, any proceeds will also be shown in the operating section.

Significant noncash acquisitions of operating assets would be handled as they are under existing Generally Accepted Accounting Principles (GAAP). Because the SCF should reflect only transactions that result in a debit or credit to cash during the period, these transactions wouldn't be shown on the SCF but would be disclosed. Ideally, subsequent cash payments (excluding interest) would be classified as operating outflows, but tracking these amounts would be problematic. Thus, all cash payments related to a company's debt or equity securities—even those initially issued in a direct exchange for operating assets—would be shown as financing outflows. Although this is an imperfect solution, the disclosures should allow management accountants to make any needed adjustments to operating cash flows during the period when the asset is acquired.

Income taxes. Current GAAP permits intraperiod allocation of income tax expense only in limited circumstances (that is, for gains and losses from discontinued operations and extraordinary items, which are shown net of tax). In particular, there's no allocation of the portion of income taxes attributable to operating income. Although not discussed in the *Accounting Standards Codification*™, SFAS No. 95 indicates that the FASB considered allocating income taxes paid among the sections of the SCF but decided that the costs would outweigh the benefits. The treatment of income taxes is, therefore, generally consistent between the income statement and the SCF.

Table 3: 2009 STATEMENT OF CASH FLOWS

		PROPOSED METHOD	CURRENT METHOD
Cash flows from operating activities			
Cash collected from customers		$520,000	
Cash paid to suppliers		−315,000	
Gross cash margin		205,000	
Cash flows for operating expenses:			
Rent	$−65,000		
Wages	−97,000		
Purchase of equipment	−75,000		
Sale of equipment	8,000		
Total cash paid for operating expenses		−229,000	
Net cash used by operating activities		−24,000	20,000
Cash flows from investing activities			
Interest received	2,000		
Sale of investment bonds	30,000		
Net cash provided by investing activities		32,000	−37,000
Cash flows from financing activities			
Interest paid	−12,000		
Payment of note	−50,000		
Dividends paid	−15,000		
Sale of common stock	100,000		
Net cash provided by financing activities		23,000	35,000
Net increase in cash before income taxes		31,000	
Cash paid for income taxes		−13,000	
Net increase in cash		18,000	18,000
Cash, January 1, 2009		15,000	15,000
Cash, December 31, 2009		$33,000	$33,000

It follows logically that if allocation isn't feasible, income taxes paid shouldn't be attributed to any specific section. This is the fundamental procedure followed in the income statement where income taxes are shown just before net income (or income from continuing operations or income before extraordinary items, if applicable). Yet for reasons never explained, the FASB required that all income taxes paid be classified as operating cash outflows. The analogous income statement treatment would be to charge all income taxes against operating income, a clearly undesirable and "unfair" approach. Although allocation may be desirable, if it truly isn't feasible, the only appropriate option is to exclude cash paid for income taxes from all three sections of the SCF. Our approach lists cash paid for income taxes as a separate line item on the SCF, just before the calculation of the net increase or decrease in cash.

With these points in mind, we present our suggested format for the SCF in Table 3. For comparative purposes, the far right-hand column indicates the subtotals for each section that would result under current accounting standards. A complete direct-method SCF, using current GAAP, is shown in Table 4.

Because each company is unique, it's difficult to generalize how our proposed method would change the results of cash flow reporting. In this example, it results in some rather large differences in the subtotals for each section

Table 4: 2009 STATEMENT OF CASH FLOWS UNDER GAAP, DIRECT METHOD

Cash flows from operating activities		
Cash received:		
From customers		$520,000
From interest		2,000
Cash paid:		
To suppliers		−315,000
For rent		−65,000
For wages		−97,000
For interest		−12,000
For income taxes		−13,000
Net cash provided by operating activities		20,000
Cash flows from investing activities		
Sale of equipment	$8,000	
Purchase of equipment	−75,000	
Sale of investment bonds	30,000	
Net cash used by investing activities		−37,000
Cash flows from financing activities		
Payment of note	−50,000	
Dividends paid	−15,000	
Sale of common stock	100,000	
Net cash provided by financing activities		35,000
Net increase in cash		18,000
Cash, January 1, 2009		15,000
Cash, December 31, 2009		$33,000

when compared to the current method. Even though the new method excludes cash paid for interest and taxes from the operating section, operating cash flows are significantly less than they would be under SFAS No. 95, primarily because of the classification of cash paid for equipment as operating rather than investing, which is also the main reason that investing cash flows are higher under our proposed approach. The effect on the financing section is less significant since the only change is the reclassification of interest paid from operating to financing. Of course, the result would be much different if a company pays large amounts of cash interest. At any rate, there's sufficient detail to allow management accountants to identify the nature of each item and make adjustments, if desired, that would allow them to compare the proposed SCF format with the current format.

Summary and Conclusions

It's been more than 20 years since the FASB improved financial reporting by requiring businesses to prepare a statement of cash flows. Here are four changes that would refine this document and make it more useful:

- Cash interest received should be shown in the investing section, not the operating section.
- Cash interest paid should be shown in the financing section, not the operating section.
- Cash paid for purchases of operating assets (and cash received from operating asset dispositions) should be shown in the operating section, not the investing section.
- Cash paid for income taxes shouldn't be included in any of the three cash flow categories (it's currently in the operating section) but should be shown separately in the SCF, just before the net increase or decrease in cash.

We also propose that all companies be required to show a subtotal for operating income. Under our approach, each line item in the operating income section of the income statement would have a corresponding line in the SCF's operating section. Anything not included in operating income would appear in the investing or financing sections of the SCF. If these suggestions are implemented, there would be greater consistency between the income statement and the SCF, enhancing the usefulness of both statements. The FASB should consider making these changes to improve financial reporting. **SF**

Bruce Wampler, CPA, DBA, is an associate professor of accounting at the University of Tennessee at Chattanooga. You can reach him at (423) 425-4664 or bruce-wampler@utc.edu.

Harold C. (Carl) Smolinski, DBA, is an associate professor of accounting at Louisiana State University in Shreveport. You can reach him at (318) 797-5014 or carl.smolinski@lsus.edu.

Timothy Vines, Ph.D., is an associate professor of finance at Louisiana State University in Shreveport. You can reach him at (318) 797-5013 or timothy.vines@lsus.edu.