Journal of Business & Leadership: Research, Practice, and Teaching (2005-2012)

Volume 1
Number 1 *Journal of Business & Leadership*

Article 26

1-1-2005

Evolution of The Cash Flow Statement Through 2003

Rita Jones
Columbus State University

Keith Atkinson
University of Central Arkansas

Follow this and additional works at: http://scholars.fhsu.edu/jbl

Part of the Business Commons, and the Education Commons

Recommended Citation
Jones, Rita and Atkinson, Keith (2005) "Evolution of The Cash Flow Statement Through 2003," *Journal of Business & Leadership: Research, Practice, and Teaching (2005-2012)*: Vol. 1 : No. 1 , Article 26.
Available at: http://scholars.fhsu.edu/jbl/vol1/iss1/26

This Article is brought to you for free and open access by FHSU Scholars Repository. It has been accepted for inclusion in Journal of Business & Leadership: Research, Practice, and Teaching (2005-2012) by an authorized editor of FHSU Scholars Repository.

Journal of Business and Leadership: Research, Practice, and Teaching
2005, Vol. 1, No. 1, 228-233

EVOLUTION OF THE CASH FLOW STATEMENT THROUGH 2003

Rita Jones, Columbus State University
Keith Atkinson, University of Central Arkansas

Cash flows of a business are the most fundamental events upon which accounting measurements are based and upon which investors and creditors are assumed to base their decisions. Then why did the FASB wait until November 1987 to issue a standard "requiring" businesses to provide a Statement of Cash Flows, and what subsequent changes have been made to the standard? Possibilities of the delay include: (1) fear of regressing from accrual accounting emphasis to a cash emphasis; (2) the area of cash flows was not perceived to be "urgent" enough to warrant the attention of the standard-setting bodies; and (3) pressure from practitioners and political groups on standard-setting bodies forced the delay. Once passed, SFAS No. 95, "Statement of Cash Flows" has been amended by two additional standards, SFAS 102 and 104, in February and December 1989, respectively. SFAS 102 deals primarily with Cash Flows from Hedging Transactions, while SFAS 104 pertains to Cash Flows from Certain Securities Acquired for Resale.

Introduction

Cash flows of a business enterprise are the most fundamental events upon which accounting measurements are based and upon which investors and creditors are assumed to base their decisions (Hendriksen, 1982). According to Ijiri (1978), "cash flow is the basic objective in business." If this is true, and most of the literature seems to suggest that it is, why did our accounting, standard-setting bodies wait until November 1987 to issue the first official pronouncement "requiring" businesses to provide a Statement of Cash Flows to their financial statement users?

There are several possible reasons. One reason might be the fear of regressing from the emphasis of accrual accounting to that of cash-basis accounting. Another might be that the area of cash flows was not controversial enough to warrant or attract enough attention from the standard-setting bodies. A third possibility could be that pressure from practitioners and political groups on standard-setting bodies forced the delay. This list is not intended to be all-inclusive; rather, the three possible reasons noted are a beginning to understanding the answer to the question presented.

The objectives of this paper are to: examine, individually, the reasons why a required cash flow financial statement was so long in coming, delineate where the profession is today in terms of cash flow reporting, and anticipate what the future may bring in the area of cash flow reporting.

Resistance to Cash Flow Reporting

Cash vs. Accrual Accounting

The cash or "funds" statement can be traced back at least to 1863 in the United States when the Northern Central Railroad issued a reconciliation of their January 1 and December 31 cash balances. According to Thompson and Buttross (1988), they included details regarding cash receipts and disbursements in the reconciliation. In the early 1900's, William Morse Cole, inventor of Morse Code, is credited with developing the first "funds" statement (Houghton Mifflin Co., 1908).

The Northern Central and Cole are only two examples of what was a widespread practice during these years-businesses were attempting to fill the information gap by reporting cash or "funds" information about their companies in the form of a funds flow statement. Cole's emphasis on funds flow escalated, and in the 1920s the need for the funds statement became more apparent to others. During this period bankruptcies were common, and financial statements were viewed as unreliable, as noted by W. E. Hooper (1915) in Railroad Accounting. In the period between 1925 and 1950, the working capital basis "funds" statement gained greater acceptance (Rosen and DeCosten, 1969). (Although it is beyond the scope of this paper to discuss the pros and cons of "cash flow" versus "funds flow," the reader should understand that there was much debate during this period as to what constituted "funds.") There was neither standardization of information content nor format, but it was evident there was a need to expand financial reporting beyond the balance sheet and income statement. Still, the accounting, standard-setting bodies did not address this need.

It was not until 1961 that the American Institute of Certified Public Accountants (AICPA) first became involved in the questions encompassing the cash flow/funds flow statement. Commissioned by the AICPA research division, Perry Mason (1961) authored

Journal of Business & Leadership: Research, Practice, and Teaching (2005-2012), Vol. 1 [2005], No. 1, Art. 26

the work, Accounting Research Study No. 2 (ARS 2), "'Cash Flow Analysis and The Funds Statement."

It was in the Director's Preface to ARS 2, that Maurice Moonitz, Director of Accounting Research at the research division, made some interesting personal observations. He referred to the concept of "cash flow" as amorphous, and went on to discount the importance of this type of reporting. He emphasized that for years a long struggle had been going on to develop the accrual basis of accounting, and that this development was in an effort to overcome the shortcomings of cash-basis accounting. He appeared frustrated by the emphasis on "funds flows" and "cash flows" and viewed them as running counter to the movement to perfect an accrual accounting (Mason, 1961).

Cash Flows Viewed by the Standard-Setting Bodies

Negative Attitude

Unfortunately, the attitude of the accounting profession toward cash flows has been rather negative. The opinion of Maurice Moonitz noted earlier was one example, and another occurred in 1963 when the Accounting Principles Board (APB) issued Opinion No. 3, (APBO 3), "The Statement of Source and Application of Funds."

Optional Reporting

In APBO 3, the APB implemented Mason's conclusions from ARS 2 and selected the "all financial resources" method of presenting the funds flow statement. However, APBO 3 left the inclusion of the funds flow statement as part of the financial statements as "optional". Also, APBO 3 contained a strong statement warning against the use of cash flows as a performance measure.

> The amount of funds derived from operations cannot be considered as a substitute for or an improvement upon properly determined net income as a measure of results of operations and the consequent effect on financial position. Misleading implications can result from isolated statistics in annual reports of "cash flow" which are not placed in proper perspective to net income figures and to a complete analysis of source and application of funds. "Cash flow" and related terms should not be used in annual reports and in such a way that the significance of net income is impaired...

As direct result of APBO 3, the increased emphasis on cash flow statements during the 1950s was largely eliminated (Ijiri, 1978). One positive outcome from APBO 3 was that those large companies, who were already preparing a cash flow or funds flow statement, for a large part, continued to do so. Many shifted their emphasis from cash flow to the funds flow concept. By the late 1960s the companies reporting based on a funds flow approach outnumbered those reporting on a cash flow basis by two to one (Rosen 1969).

Pressure to Delay/Implement Cash Flow Statement

For the accounting, standard-setting bodies, the period from the late '60s through the present has been like a continuous "bumper car" ride in the area of cash flow and funds flow reporting. The standard-setting bodies would gain momentum, come to a screeching halt, and then either back up to re-think their position and change direction, or go forward again in a similar manner.

A summary of the activity regarding cash flow and funds flow reporting during this period includes the following: the APB issued one opinion, the AICPA formed a study group, the Financial Accounting Standards Board (FASB, replaced the APB in 1973): (1) issued one discussion memorandum, (2) held a public hearing, (3) issued three exposure drafts, (4) organized a task force specifically to study the topic of cash flow reporting, and (5) issued one statement. It is important at this point to look at the above activities in greater detail.

Political Pressure

Concerning the APB, the Securities and Exchange Commission (SEC) had been openly critical of their lack of effectiveness. The APB's view that the funds flow statement should be optional was overshadowed by the SEC's requirement in 1969 that a funds flow statement be included in the annual filings of companies already reporting to the SEC. Historically, this change was probably prompted by the so-called liquidity crisis during this period (Ketz and Largay, 111, 1987). Whatever the reason, the APB was forced to reconsiderAPBO3.

Reporting Requirement

The statement of changes in financial position became a requirement for all companies when the APB issued Opinion No. 19 (APBO 19), "Reporting Changes in Financial Position," in March 1971. APBO 19 permitted changes in financial position to be expressed in terms of cash, cash and temporary investments combined, all quick assets, or working capital, as long as the all financial resources concept of APBO 3 was

continued (Thompson, 1988). Also under APBO 19, the presentation of the "funds provided by operations" could be either under the direct or the indirect method. (The indirect method was used predominantly.)

Financial Statement Objectives

In April 1971, the AICPA formed "The Study Group on the Objectives of Financial Statements." Otherwise know as the Trueblood Committee. This name, of course, stemmed from the chairman, Robert M. Trueblood (Wolk, Francis, and Tearney, 1989). The committee findings were issued in 1973 in the Trueblood Report and later used as the basis by the FASB to develop Statement of Financial Accounting Concept No. 1 (SFAC 1), "Objectives of Financial Reporting by Business Enterprises." This report is important because one objective of financial statements as seen by the Trueblood Committee was: ". . . to provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows to them in terms of amount, timing, and related uncertainty (Sorter, 1982). This was incorporated, almost verbatim, into SFAC 1 in 1978.

Lack of Support

The opposition to the funds flow statement was still alive and still voiced the same objection. That is, the opponents interpreted the emphasis on cash in the Trueblood Report as rejecting accrual accounting and establishing the centrality of the cash receipts and disbursements statement. This was not the intention of the study group (Sorter, 1982). The opponents obviously did not possess the breadth of vision to realize that both the concept of accrual accounting and the concept of a funds flow or cash flow statement could co-exist.

However, the FASB finally grasped this idea, and via SFAC 1 asserted that the emphasis on cash was not in opposition to, but congruent with, accrual accounting. In any event, whether because of the improved explanations or the intervening five years, the very objectives so vehemently objected to in 1973 were found to be universally acceptable in 1978 (Sorter, 1982).

Back to Cash

As of 1978 it had taken approximately one hundred years for the profession to come full circle back to cash flow reporting. What an interesting phenomenon! This new acceptance of the cash flow concept paved the way for a movement toward a cash flow statement that would be universally applicable. In 1978, Ijiri suggested that cash flow information would be very useful to investors and creditors, and in his article, offered the reporting categories of "investing and financing" as being of significant interest to these external groups. His vision of the flow of accounting information regarding these activities is indicated by the flowchart in figure 1 at the end of this paper.

FEI Leads the Way

In December 1980, the FASB issued a Discussion Memorandum (DM), "Reporting funds Flows, Liquidity, and Financial Flexibility," and held a public hearing to discuss the issues raised in the DM. While the FASB was busy "talking" about the cash flow issue, the Financial Executives Institute (FEI) took action. In late 1981, the FEI encouraged its members to change to a focus on cash and short-term investments in their funds statements. It also encouraged enterprises to experiment with alternative formats, such as grouping items by operating, investing, and financing activities. Once again, the FASB was caught off-guard.

The FA SB Picked Itself Up

In an attempt to regain credibility and strengthen their position, the FASB issued SFAC 5, "Recognition and Measurement in Financial Statements of Business Enterprises," in December 1984. Regarding a cashflow statement, SFAC 5, indicates that:

> It 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; about its financing activities, both debt and equity; and about its investing or spending of cash. Important uses of information about an entity's current cash receipts and payments include helping to assess factors such as the entity's liquidity, financial flexibility, profitability, and risk.

The SFAC 5 project was issued under much external pressure and criticism and contains many compromises between the members of the FASB.

Between November 1981 and July 1986, the FASB issued three exposure drafts relating to cash flows. These finally led to the issuance, in November 1987, of the Statement of Financial Accounting Standards No.95 (SFAS 95), "Statement of Cash Flows."

Statement of Financial Accounting Standards No. 95

Scope and Purpose

According to SFAS 95, "A business enterprise that provides a set of financial statements that reports both

financial position and results of operations shall also provide a statement of cash flows. The primary purpose of the statement is to provide "relevant information about the cash receipts and cash payments of an enterprise during a period." The statement was effective for fiscal years ending after July 15, 1988.

Statement Requirements

Classifications

The structure of the cash flow statement sub-classifies cash receipts and disbursements in operating, financing, and investing activities (Wolk, 1989). This type of classification probably sounds familiar. That is because it is the same as that suggested by the FEI in 1981, and similar to that set forth by Ijiri in 1978.

Cash

Cash is defined as cash on hand or on demand deposit, plus cash equivalents. Cash equivalents are highly liquid investments that are convertible to known amounts of cash and that have an original maturity of three months or less (Wolk, 1989).

Direct or Indirect

The FASB did allow some flexibility in that **SFAS 95** encourages the use of the direct method in presenting the cash flow statement. But the indirect method is also acceptable.

Gross Cash Flows

Most investing and financing cash inflows and outflows must be presented as gross amounts rather than as net changes in related balance sheet amounts. There are limited exceptions, including one for assets and liabilities with original maturities of three months or less (Mahoney, Sever, and Theis, 1988).

Foreign Cash Flow Concerns

Companies with foreign currency transactions or foreign operations must present the reporting currency equivalent of foreign currency cash flows, using the exchange rate at the time of the cash flows. Also, the effect of exchange rate fluctuations on foreign currency cash balances must be presented separately (Mahoney, 1988).

Reporting Cash Flow Information in 2003

SFAS 102 and SFAS 104

There have been two statements issued subsequent to SFAS 95 that amended it, SFAS 102 and 104, according to the FASB web site. SFAS 102 is titled, Statement of Cash Flows-Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale--an amendment of FASB Statement No. 95. The purpose was to exempt from the requirement to provide a statement of cashflows: (a) defined benefit pension plans covered by FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, and certain other employee benefit plans and (b) highly liquid investment companies that meet specified conditions.

This statement also requires that cash receipts and cash payments resulting from acquisitions and sales of. (a) securities and other assets that are acquired specifically for resale and carried at market value in a trading account and (b) loans that are acquired specifically for resale and carried at market value or the lower of cost or market value be classified as operating cash flows in a statement of cash flows. This statement was effective for financial statements issued after February 28, 1989.

SFAS 104, Statement of Cash Flows-Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions-an amendment of FASB Statement No. 95, was effective for annual financial statements for fiscal years ending after June 15, 1990. It amends SFAS 95 to permit banks, savings institutions, and credit unions to report in a statement of cash flows certain net cash receipts and cash payments for (a) deposits placed with other financial institutions and withdrawals of deposits, and (b) loans made to customers and principal collections of loans. In addition, this amendment allows cash flows resulting from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events to be classified in the same category as the cash flows from the items being hedged provided that accounting policy is disclosed.

Other than these two statements, the reporting requirements of SFAS 95 remain in tact. The next timeframe to consider is the future of the cash flow statement.

Cash Flows Reporting in the Future

Investor's Demands

Considering the company failures during the early 2000's, it would seem that investors would demand more reliable financial information, especially regarding cash flows, from companies they currently invest in, and/or might potentially invest in. Additional regulations

are being proposed by congress, but none of the changes specifically targets the cash flow statement. There will probably not be any significant modification to SFAS 95, such as requiring companies to report using the direct format for the cash flow statement, unless pressure is brought to the FASB by the users of this statement.

Segment Cash Flow Statements

What does the future hold in the area of cash flow reporting? In 1988, Bracken and Volkan believed that the cash flow statement could and should be expanded to encompass segments of a business. In addition, they advocated interim reporting using the cash flow statement. Anecdotal information suggests that companies are using the cash flow statement as part of their interim reporting packages.

Impact of Technology Advances

The impact of electronic technology relative to filings with the SEC is an area of study currently in "vogue" in the field of accounting. This topic was studied by the FEI in 1987, and some interesting conclusions from their study warrant repeating: (1) this technology will allow users to aggregate or disaggregate file data; and (2) this technology advance will allow for disclosure of data that is more disaggregated than at present. It would appear that the increased flexibility of extracting needed information using the database concept will be relevant to all financial statement users.

In addition, technology advances would also make it more cost-effective for companies to report their Statement of Cash Flows using the direct format for reporting compared to the costs when the statement was first required in 1987. One of the major complaints according to responses from companies to exposure drafts was the prohibitive cost of reporting under the direct format at that time. The transition from the Funds Flow Statement to the Cash Flow Statement using the indirect method was a relatively simple change, but is less user-friendly for investors.

Conclusions

Where standard-setting bodies are concerned, political and private pressures will always exist. The standard-setting bodies that are successful will be the ones who effectively deal with these pressures. The FASB has been subjected to pressures from political and private groups. Whether or not they have been effective will be a matter for hindsight to judge. However, they are still in existence after twenty-nine years.

The FASB has played the role of follower rather than leader in setting the standard for cash flows. At least the profession has SFAS 95, and for the most part, it appears to satisfy the information gap, which existed for so long. Maybe the FASB has the right attitude-test the waters cautiously, do not be the first to come forth with a "new" idea, and after months (sometimes years) of discussing a "new" idea, pass a standard indicating how the accounting profession had addressed the issue before the standard was issued.

REFERENCES

American Institute of Certified Public Accountants. **The statement of source and application of funds.** APB Opinion No. 3. AICPA, October 1963.

Bracken, R., & Volkan, A. 1988. Cash flows - A new reporting format for turbulent times. **Management Accounting,** January: 38-41.

Cole, W. 1908. **Accounts - Their construction and interpretation.** Boston: Houghton-Mifflin Co.

Financial Accounting Standards Board. 1978. **Objectives of financial reporting by business enterprises. Statement of financial concepts No. 1.** FASB, (November 1978).

Financial Accounting Standards Board. 1984. **Recognition and measurement in financial statements of business enterprises. Statement of financial concepts No. 5.** FASB, (December 1984).

Financial Accounting Standards Board. 1987. **Statement of cash flows. Statement of financial accounting standards No. 95.** FASB, (November 1987).

Financial Accounting Standards Board. 1989. **Statement of cash flows - Exemption of certain enterprises and classification of cash flows from certain securities acquired for resale - An amendment of FASB Statement No. 95. Statement of financial accounting standards No. 102.** FASB, (February 1989).

Financial Accounting Standards Board. 1989. **Statement of cash flows - Net reporting of certain cash receipts and cash payments and classification of cash flows from hedging transactions - An amendment of FASB Statement No. 95. Statement of financial accounting standards No. 104.** FASB, (December 1989).

Financial Executives Institute. 1987. **The impact of electronic technology at the SEC.** Morristown, NJ: FEI.

Hendriksen, E. 1982. **Accounting theory.** Homewood, IL: Irwin.

Hooper, W. 1915. **Railroad accounting.** D. Appleton and Co.

Ijiri, Y. 1978. Cash-flow accounting and its structure. **Journal of Accounting,** Summer: 331-348.

Ketz, E., & Largay, J. 1978. Reporting income and cash flow from operations. **Accounting Horizons,** June: 9-17.

Mahoney, J., Sever, M., & Theis, J. 1988. Cash flow: FASB opens the floodgates. **Journal of Accountancy,** May: 26-38.

Mason, P. 1961. **Cash flow' analysis and the funds statement. Accounting research study No. 2.** New York: AICPA.

Rosen, L., & DeCosten, D. 1969. Funds' statements: A historical perspective. **Accounting Review,** January: 124-136.

Sorter, G. 1982. The emphasis on cash and its impact on the funds statement - Sense and nonsense. **Journal of Accounting, Auditing and Finance,** Spring: 188-194.

Thompson, J., & Buttross, T. 1988. Return to cash flow. **CPA Journal,** March: 30-40.

Wolk, H., Francis, J., & Tearney, M. 1989. **Accounting theory - A conceptual and institutional approach.** Boston: PWS-Kent.

Rita Jones is an associate professor of accounting at Columbus State University. She received her Ph.D. in accounting from Mississippi State University. Her current research interests include financial and cost/managerial accounting topics as well as business ethics. She has published in Journal of Accounting and Finance Research, Journal of Business, and Industry and Economics. In addition, she has co-authored three accounting practice sets for classroom use.

Keith Atkinson is a professor of accounting at University of Central Arkansas. He received his Ph.D. in accounting from University of Mississippi. His current research interests include auditing, financial markets, and financial accounting. He has published in Review of Accounting Information Systems, International Journal of Auditing, and CPA Journal.