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The persistence of current and proposed measures of operating cash flow

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ABSTRACT

The measurement of operating cash flow using U.S. generally accepted accounting principles (GAAP) currently requires deductions for interest and income tax payments, and prohibits deductions for capital expenditures. In contrast, the IASB and the FASB are jointly proposing a new measure of operating cash flow which prohibits deductions for interest and income tax payments, and requires deductions for capital expenditures. This study compares the persistence of the current and proposed measures of operating cash flow, and the industry-specific results indicate that there is no significant difference between the persistence of the two measures for more than three-fourths of the industries in the sample. Moreover, the Boards' constituents are recommending the use of a subtotal of operating cash flow *prior* to capital expenditures, and the results of this study suggest that this subtotal is more persistent for a limited number of industries than the current measure. Overall, the results of this study suggest that the predictive ability of operating cash flow will not change significantly for most industries.

1. Introduction

The Financial Accounting Standards Board recognizes through its Statement of Financial Accounting Concept No. 8, Chapter 1 par. OB3, that financial statement users "...need information to help them assess the prospects for future net cash inflows to an entity."[3] Accordingly, an important objective of the cash flow statement is to inform capital providers of the firm's prospects for generating and replicating cash flow from operations in future periods. The measurement of operating cash flow using U.S. generally accepted accounting principles (GAAP) currently requires deductions for interest and income tax payments, and prohibits deductions for capital expenditures. In contrast, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (hereafter, the Boards) are jointly proposing a new measure of operating cash flow which prohibits deductions for interest and income tax payments, and requires deductions for capital expenditures. A natural question then arises concerning

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[3] Although the Statement of Financial Concept No. 8 was issued in 2010, the Financial Accounting Standards Board (1978) recognized investors' need for information to assess future cash flows in prior concepts statements. This was explicitly stated as a financial reporting objective in Statement of Financial Accounting Concept No. 1, par. 37 "... Thus, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise." The Financial Accounting Standards Board (1980) reiterated this objective in its Statement of Financial Accounting Concept No. 2, par. 22. These concept statements were issued in 1978 and 1980, respectively. Thus providing information helpful in assessing (predicting) future cash flows has been an objective of financial reporting for over thirty years.

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Proposed Statement of Cash Flows

	For the Years Ended December 31, 20X1	20X0
BUSINESS:		
Operating		
Cash collected from customers	$2,813	$2,572
Cash paid for labor	–810	–845
Cash paid for materials	–936	–785
Cash contribution to pension plan	–340	–315
Cash paid for leases	–311	–243
Capital expenditures	–16	–50
Sale of receivables	8	11
Net cash flow from operating activities	**$ 408**	**$ 345**
Investing		
Net change in short–term investments	–300	–800
Investment in Company A	–	–120
Dividends and interest received	63	56
Purchase of equity securities	56	–80
Net cash flows from investing activities	**–181**	**–944**
Net Cash Flows from Business Activities	**226**	**–599**
FINANCING:		
Dividends paid	–86	–80
Interest paid	–83	–83
Proceeds from reissuance of treasury stock	84	78
Proceeds from issuance of long–term debt	162	400
Net Cash Flows from Financing Activities	**76**	**315**
Net Cash Flows from Continuing Operations before Taxes	303	–284
INCOME TAX:		
Total cash paid for income tax	**–281**	**–194**
Change in cash before discontinued operations and Effects of foreign exchange	22	–477
DISCONTINUED OPERATIONS:		
Net cash outflows from discontinued operation	–13	–12
Effect of Foreign Exchange	3	1
Change in Cash	**$ 12**	**$ -488**

Fig. 1. Proposed statement of cash flows.

whether the current or proposed measure of operating cash flow is more informative for predicting future operating cash flow.[4] The current study answers this question by comparing the persistence of the two measures for one-year-ahead operating cash flow.

Fig. 1, adapted from the Financial Accounting Standards Board's (2010b) Staff Draft ¶IG28, contains a sample of the proposed cash flow statement, where interest payments appear in the financing section, income tax payments appear in the income taxes section, and capital expenditures appear in the operating section. Repositioning interest payments from the operating section and into the financing section is consistent with the results of a FASB field test, which indicates that separating business and financing activities is among the three most useful aspects of the proposed model (see ¶BC21 from FASB Staff Draft, July 2010). Through recent interviews with financial statement users, the FASB discovered that free cash flow is a key financial measure used by investors and creditors to evaluate financial performance. This is consistent with the Boards' proposal, where most firms will reclassify capital expenditures from investing activities to operating activities. The Boards' decision to segregate income tax cash flows is largely the result of problems associated with allocating income tax benefits/payments to various activities such as operating, investing and financing. In sum, the

[4] In general, this study examines two measures of operating cash flow: (1) the current measure specified by SFAS No. 95; and a proposed or new measure currently under consideration by the Boards. In addition to the classifications for interest, taxes and capital expenditures, the Boards' proposed measure for operating cash flow differs from SFAS 95 in several other respects. For example, interest and dividend receipts will most likely be components of investing cash flow, nonfinancial firms will classify cash flows related to investing gains and losses from trading securities as investing activities, and cash payments related to notes held by suppliers will most likely be classified as operating. However, differences related to expenditures for interest, taxes and capital assets are larger in magnitude than the other differences. Moreover, the Compustat database does not contain the actual cash flow variables for these other differences.