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REPORTING CASH FLOW INFORMATION

An Address by

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Good morning,

I am delighted to have an opportunity to speak before this distinguished group.

"Deregulation"

Deregulation, one of the most over used words of this, and the past two administrations, has been said to be the theme of the Securities and Exchange Commission of today. In many respects that is probably true, but it would be naive to think that a responsible agency like the SEC would take that watch-word to mean taking apart the framework of regulation that has taken almost half a century to fashion -- much of which has been responsible for the protection of investors and the maintenance of honesty and integrity in our securities markets, which are conceded by all to be the best in the world.

Thus, it seems appropriate to spend a few minutes discussing my views, at least, as to how the present emphasis on "DEREGULATION" at the SEC should affect accountants and accounting, after which, I will talk a bit about a specific topic that is likely to be of concern to us all -- reporting cash flow information.

Self-Regulation

As you know, the Securities Acts gave the Commission broad powers designed to protect investors in their securities transactions. These powers include the authority to promulgate rules to provide full and fair disclosure -- the key to our system of regulation.

In the important area of accounting, the Commission has, throughout its 50-year history, placed extensive reliance on the private-sector financial reporting system which, historically, has served investors and the public well. It is this reliance on self-regulation by the private-sector which is the cornerstone of deregulation.

However, despite its reliance on self-regulation by the private sector with respect to accounting matters, the Commission cannot, and will not, abdicate its own responsibilities in this area. Accordingly, the Commission's approach to deregulation requires that it closely oversee the activities of private standard-setting organizations, and maintain its own accounting and reporting rules to address areas which are unique to Commission filings or where generally accepted accounting principles are not explicit. Even though the Commission has only occasionally determined that it was necessary to step in and provide interim resolutions to new or changing accounting issues it is incumbent upon us to be prepared to do so. It is clear, however, that the success of the Commission's deregulatory efforts in the accounting area depends, to a large extent, upon the continued effectiveness of the private-sector regulatory groups.

The FASB, for example, faces some complex and controversial issues on its current agenda. Major projects, such as pensions and income taxes, plus narrower issues, such as transfers of receivables with recourse, and research and development financing arrangements, pose significant challenges to the Board and the financial community. Further, there is a continuing need for the Board to address -- in a timely and effective manner -- the various emerging problems that constantly arise in our rapidly changing economic environment.

The Commission's recent deregulatory initiatives in the accounting area involve two separate but related phases. First, a comprehensive reexamination of our accounting requirements, and second, an increase in the effectiveness of our oversight function in order to place even greater reliance upon the private-sector self-regulatory bodies. During the past year or so, the Commission has devoted much of its resources to the first phase -- streamlining and simplifying its existing accounting and reporting rules. The objective has been to reduce regulatory burdens without sacrificing the integrity of financial disclosures. As we complete this project, we will be devoting more of our resources to the oversight role. Particularly, the staff's efforts will be focused in three directions: (1) gaining a better and earlier understanding of the Board's direction on specific issues; (2) evaluating the theoretical basis and practical implications of the conceptual framework project, and (3) analyzing emerging accounting problems.

It is important to emphasize, however, that notwithstanding the Commission's focus on deregulation, I believe that the Commission <u>must</u> give priority to fulfilling its statutory responsibilities and therefore should not hesitate to take regulatory action in the accounting and reporting areas, if necessary. Thus, it is your continued commitment to effective self-regulation that is a vital component of the Commission's program of deregulation.

Reporting Cash Flows

Turning now to a specific area of my concern, and one of the more important issues in the accounting and financial reporting arena today, is the development of cash flow reporting.

In my view, the activities in this area are an excellent example of how the cooperative efforts of the public and private sectors can contribute to the provision of more useful, yet cost-effective, financial information for investors, creditors and others. This is also an area where I believe the accounting process has the opportunity and, in fact, the obligation to make a major contribution to sound business and investment decisions -- and by extension to the health of our capital markets and our overall economy. Not only is cash flow information itself vital to the analysis of investment risk, but cash flow considerations are also important in evaluating other key current accounting issues.

Accordingly, in my discussion of cash flow reporting today I will address the following questions:

1) First, why is cash flow data needed, and why has interest in it recently accelerated?

2) Second, what has been done in this area to date?

3) Third and most important, what still remains to be done?

To begin with, we need a little background: I find it somewhat amazing that for over five hundred years, indeed until the 1930's, the central focus of accounting and financial reporting was on cash flow and solvency. Yet, for the past fifty years -- which includes the entire lifespan of the Commission to date, and the period of greatest development of public external reporting in the United States -- the financial community has been obsessed with the income statement and its all-important bottom-line figures -- net income and earnings-per-share.

Since the mid-70's, however, demands for cash flow data have become increasingly frequent and widespread. I believe that there are two reasons why thinking has seemingly come full circle in a relatively short period. First, as I will discuss later, there is a clear connection between the state of the economy and the priorities of financial statement users. When times are hard, people care more about immediate cash value than about uncertain future prospects. Second, preparers and users alike are recognizing that accrual basis earnings and earnings-per-share-data are not sufficient to adequately assess the the performance of an enterprise. Instead, a much broader concept of reporting is required -- one which also provides information about an enterprise's cash resources and obligations, and its ability to generate cash from operations or otherwise.

Over time, the accounting equation does require of course that accrual earnings equal cash earnings, but in the short-term, timing variations between accruals and cash flows may be quite significant; they may even make the crucial difference between continuing operations and bankruptcy. In other words, although accrual accounting, with its matching of revenues and expenses, may be important to the analysis of long-term profitability, cash flow is vital to survival.

Since the perils of ignoring cash flow information are so substantial, one might ask why they are only now coming to the forefront. The answer is simple -- the perils rarely materialized during the generally steady economic growth of the 1940's to early 70's. Because of relatively stable prices and high liquidity, accrual earnings tended to track cash flows for most industries. Under conditions of rapid inflation and recession, however, the gap between accruals and cash inevitably widens. Earnings computed on the basis of historical costs do not square with expenditures to replace or expand facilities, inventories, and other components of working capital, since these expenditures are made at higher current costs. If cash generated internally is inadequate to fund the escalating outflows, companies may be forced to obtain additional, often high-cost, outside financing or to cut expenditures. Either alternative can put further strains on both earnings and cash resources, and these strains may, in turn, decrease stock market attractiveness, and aggravate the company's financial problems.

Circumstances such as these can have -- and have had -- devastating results. First, in the late 60's and early 70's and now in the past few months, several large corporate bankruptcies and near-bankruptcies have stunned the financial community. The financial press has also pointed out that on an overall basis, the liquidity of American companies is dangerously low. These failures have motivated a broad-based and long overdue interest in the importance of cash flow and cash flow reporting.

Initiatives in Cash Flow Reporting

The initiatives in this area have come from the accounting profession and the business community, as well as from government regulatory bodies. First, in 1973, the Robert Trueblood report identified cash flow information as one of the primary objectives of financial reporting. The Financial Accounting Standards Board (the FASB) endorsed this view in its Conceptual Framework project, 1/ and undertook a specific project on the reporting of cash flow.

A majority of the respondents to the related discussion memorandum agreed that the present statement of changes in financial position is too often an aggregation of debits and credits without much meaning. There was also a general consensus that

1/ Statement of Financial Accounting Concepts No. 1, issued in November 1978, stated that "Financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash in-flows to the related enterprise."

the use of a working capital definition of funds is outmoded and more confusing than informative. It should be replaced by a cash or cash equivalents definition.

Based on these responses, the Board in its recent exposure draft on "Reporting Income, Cash Flows and Financial Position" proposes a cash flow statement, rather than a statement of Changes in Financial Position using a working capital concept. This draft also explicitly acknowledges that both the cash flow statement and the income statement are relevant to the assessment of an enterprise's current performance and future cash flows.

Although the exposure draft has not yet been adopted, I believe that it is extremely significant that the business community has already taken some of its own initiatives in this area. The Financial Executives Institute, for example, has undertaken a project encouraging its member corporations to adopt a cash flow presentation in the statement of Changes in Financial Position and to experiment with alternative formats in order to determine the most meaningful presentation for each company.

So far, I have not mentioned the Securities and Exchange Commission. Yet, the Commission has long taken an active interest in this area. In September of 1980, the Commission substantially expanded the scope of its management's discussion and analysis in order to enable investors to better understand financial transactions and appraise the quality of earnings, particularly from the standpoint of the amounts and certainties of cash flows. The revised rules specifically require discussion of the company's liquidity and capital resources and define liquidity as "the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's needs for cash." In Accounting Series Release No. 299, issued in September of 1981, the Commission further cautioned managements not to limit their discussion of cash flow to working capital and not to confuse net income adjusted for non-cash items with actual cash generated from operations.

In the context of advocating better cash flow disclosures, I should also comment on Accounting Series Release No. 142, "Reporting Cash Flow and Other Related Data." In this 1973 release, the Commission explained its view that certain approaches to cash flow reporting, especially presentations of cash flow on a per-share basis should be avoided in the narrative section of a prospectus or in the financial highlights or president's letter in annual reports, because they would "run a high risk of materially misleading investors". Shareholders, for instance, may be confused by the fact that cash-flow-per-share bears only a partial relationship, if any, to the cash dividends they receive. Because of the recent renewed interest in cash flow reporting, the Commission's staff has frequently been asked whether it plans to recommend that the Commission rescind ASR No. 142. At this point, however, there is no intent to do so because of the absence of an established definition of cash generated from operations, and the lack of guidelines established by the FASB as to the objectives of cash flow reporting.

The Commission does hope, however, that the problems cited in ASR 142 will be resolved. Currently, the new Commission requirements for management's discussion and analysis complement ASR 142 by providing guidance as to when cash flow information would be meaningful. The FASB project on "Reporting Income, Cash Flows and Financial Position" also explores the concepts of summary indicators and highlight-type information such as per-share data. We hope that the reporting standards which evolve from this project will permit us to rescind ASR 142.

What Remains to Be Done

The development of cash flow reporting thus seems to have made significant strides. Yet, I believe that an equal number of critical issues remain to be resolved. It is all very well that the FASB has endorsed the cash-basis funds statement, and that the FEI has supported this movement. However, the FASB exposure draft does not provide a specific definition of the term cash to be used in the cash flow statement. Neither does it make a choice between a presentation format which shows cash inflows and outflows from operations directly (the "direct approach") and one which merely reconciles net income to cash flow. There are also other open issues, but I believe that these two in particular are vital to the development of useful standards for cash flow disclosures.

Resolving the first of these two questions -- the selection of a definition of cash -- simply should not be that difficult. Given the structure of our financial markets today, the appropriate definition would appear to be "cash and cash equivalents". Cash equivalents could be defined as only those securities which are readily convertible to cash.

The choice of a presentation format for a cash flow statement is admittedly more controversial, if for no other reason than that it challenges current practice and human inertia. But, if the purpose of the cash flow statement is -- as stated in the exposure draft -- to provide information on cash inflows and outflows, then the weight of the evidence lies clearly on the side of the direct approach. The direct approach starts with revenues collected, omitting accruals. Then, it deducts cash expenses, excluding non-cash items such as depreciation, and all other asset write-offs and accounting allocations. In fact, depreciation and other non-cash items should not even appear on the cash flow statement. Sales of assets generate cash, purchases are reductions of cash; depreciation is neither.

Users also need to know how much additional cash was necessary for working capital, and what part of the expenditures related to expansion, as opposed to maintenance of operations. In addition to showing funds from regular operations, the cash flow statement should indicate the sources and uses of cash related to nonrecurring items and to investment and financing activities. Investment disclosures should also distinguish maintenance of capacity from expansion. The precise form of the cash flow statement should, of course, be tailored to each individual company, but the general nature of the information should be similar and should be designed to communicate, rather than to obscure key data.

In any case, it is clear that cash flow information is highly relevant to investors and other users -- especially so in today's economic environment. Cash flow obviously is also crucial to management, and in that regard, practical accounting issues are often directly tied to the need to generate cash flow. One such current issue is the accounting for transfers of receivables with recourse. In order to accelerate the conversion of receivables into cash, receivables may be pledged as collateral for loans or, alternatively, sold to third parties either with or without recourse. In non-recourse sales, the seller transfers all interest in the receivables for a fixed price. There are no strings attached to the deal. But in a recourse sale, the situation is very different. The seller retains the risk of nonpayment by the customer and may even guarantee the buyer a yield which varies with market rates. The substance of the recourse arrangement is essentially the same as the collateralized loan.

What is alarming is that the FASB doesn't see it that way. They propose to treat the recourse transaction as a sale rather than treating it similar to a collateralized loan, thus accounting for two substantially identical transactions in vastly different ways and creating an enormous potential for misleading investors. I hope the FASB will reexamine this issue and its wide-ranging implications before it adopts a final standard.

In conclusion, I would urge you all to consider the importance of cash flow reporting, and to contribute your ideas and experience in order to improve financial reporting in this area. The recent upsurge of interest in cash flow data is most directly the result of the current economic disruption -- inflation and recession. Yet, it has led to a significant advance in accounting theory --

toward the development of an integrated concept of the balance sheet, income statement and cash flow statement as equal, interrelated components of financial reporting.

Thus far, the initiatives in this area have been broad-based and worthwhile. Much, however, remains to be done in order to translate a good theory into effective practice.

If the private sector actually succeeds in this endeavor, its success will have a broader significance than just the development of cash flow reporting. It will help to convince the many skeptics (and I periodically include myself in that category) that the Commission's deregulatory efforts are defensible, and its reliance on the private sector is not misplaced.