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FASB’s Proposed Statement of Cash Flows: Its Differential Impact on Companies and Auditors

Hian C. Koh

Karen M. Collins

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By Hian C. Koh and Karen M. Collins

Introduction

In July of 1986, the Financial Accounting Standards Board issued an exposure draft, "Statement of Cash Flows" [FASB, 1986]. This draft proposes that companies be required to include a Statement of Cash Flows in place of the presently required Statement of Changes in Financial Position. The deadline for comments on this exposure draft was October 31, 1986. If a pronouncement is issued, which appears likely, the provisions of the exposure draft would be effective for fiscal periods ending after June 30, 1987. Also, comparative financial statements for prior periods would have to be restated.

The impact of FASB pronouncements on companies and auditing firms has not been uniform. Thus, it can be expected that the above pronouncement, if issued, will have a greater impact on some companies and auditing firms than on others. This article consists of two parts. The first part provides a discussion of the funds statement and the recent interest in cash flow reporting. The second part presents the details of the study along with the findings and possible implications.

Background

Funds statements have been prepared by business enterprises for a long time. In the 1800's, the funds statements were generally based on cash. However, preparers soon expanded the definition of funds and, by the early 1900's, funds statements were prepared using various concepts of funds, including cash, current assets, and working capital. By the 1920's, the primary definition of funds was working capital.

In 1971, APB Opinion No. 19 [AICPA, 1971] was issued. This required that corporate annual reports include a funds statement, to be called the Statement of Changes in Financial Position. The Opinion did not dictate one particular definition of funds but allowed each preparer to choose from the following definitions: cash, cash and temporary investments combined, quick assets, and working capital.

The FASB Conceptual Framework Project focused attention on the need for cash flow information. Then, Following Concepts Statement No. 1 [FASB, 1978], the board began active work on issues related to cash flow reporting. The FASB issued a discussion memorandum, "Reporting Funds Flows, Liquidity, and Financial Flexibility" [FASB, 1980], followed by a concepts statement exposure draft, "Reporting Income, Cash Flows, and Financial Position of Business Enterprises" [FASB, 1981]. This draft proposed that cash, rather than working capital, be the basis for funds statements. Upon consideration of the responses to the exposure draft, the Board decided not to issue a final statement but to consider the subject in conjunction with its study of recognition and measurement concepts.

In December of 1984, the FASB issued Concepts Statement No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises" [FASB, 1984], which provided general guidance on a statement of cash flows. In April 1985, after considering the results of a study by the Financial Executive Research Foundation, the FASB added a project on cash flow reporting to its agenda. The project resulted in the issuance of the exposure draft, "Statement of Cash Flows" [FASB, 1986] in July 1986.

The FASB has been advocating a switch to the cash basis for the Statement of Changes in Financial Position since 1978. Other forces — the Financial Executive Institute, the Securities and Exchange Commission, and the AICPA through its Auditing Standards Board — have joined in this advocacy. It appears that companies are responding to the encouragement. An AICPA survey in "Accounting Trends and Techniques" reveals that of the companies surveyed in 1978 (prior to the issuance of Concepts Statement No. 1), only 7% reported on a cash basis [AICPA, 1979]. This is in sharp contrast to a survey which shows that 59% of the reporting companies used the cash basis in 1984 [AICPA, 1985].

While many companies have switched to the cash basis, many others have remained with the working capital definition of funds. It is these companies, and their auditors, which will be most affected by the expected decision of the FASB to require a Statement of Cash Flows. Not only will these companies need to report on a cash basis for the current year, but they will also be required to restate prior years' statements on a cash basis for comparative purposes.

Sample Data and Statistical Analysis

The sample for this study consisted of 1,404 non-financial, public companies listed on the 1985 COMPUSTAT annual industrial tape. A large sample was chosen in order to cover a sizable cross-section of companies. The 1985 COMPUSTAT tape was used because it provides current and complete financial data for public companies of wide interest to investors and creditors.

The sample of 1,404 companies was subdivided into groups under three different classification schemes. The first classification, by size, produced eight different groups based on total assets. The second classification, by industrial code, identified 29 different industries. Finally, the companies were classified by their auditing firms. In this case, the companies were divided first into two groups (those audited by the Big Eight auditing firms and those audited by the non-Big Eight auditing firms) and then into nine groups (one group for each of the Big Eight auditing firms in addition to the non-Big Eight auditing firm group).

A Chi-square test of independence was performed for each of the three classification schemes above. Essentially, the Chi-square tests determined if the use of a particular basis (i.e., working capital or cash basis) depended significantly on the size, industry association, or auditing firm of the company under examination. Results of these statistical analyses made it possible to determine those particular groups of companies with certain characteristics more likely to use the working capital basis and which companies and auditing firms will be most affected if the Statement of Cash Flows is adopted.

Results and Implications

Overall. The majority (54.7%) of the 1,404 companies in the sample used a working capital basis in 1985. This is a higher percentage than is indicated by the most recent survey in *Accounting Trends and Techniques*, which reports that only 41% of surveyed companies used the working capital basis in 1984. The difference between the present findings and those reported in the *Trends and Techniques* survey can be explained by the fact that the companies in the latter survey were very large companies, whereas the sample in this study consisted of both large and small companies. As will be discussed below, size has a significant impact on the definition of funds used.

Size. The results of the Chi-square test of independence between the definition of funds used and the company's size are presented in Table 1. As can be seen, the definition of funds used depends significantly on the size of the company. In

TABLE 1
Chi-Square Test of Independence Working Capital Vs. Cash Basis by Firm Size (N = 1,404)

Total Assets ($ Million)	Working Capital Expected Frequency 54.7%		Cash Expected Frequency 45.3%	
	No.	%	No.	%
Less than 100	386	79.9	97	20.1
100 to less than 200	136	61.8	84	38.2
200 to less than 400	95	52.8	85	47.2
400 to less than 600	33	42.3	45	57.7
600 to less than 800	32	41.6	45	58.4
800 to less than 1000	16	32.0	34	68.0
1000 to less than 2000	34	27.4	90	72.6
More than 2000	36	18.8	156	81.2
Total Sample	768	54.7	636	45.3

Chi-Square 286.70
Significance 0.0000

Table 2
Chi-Square Test of Independence Working Capital Vs. Cash Basis by Industry Classification (N = 1,404)

Industry Code	Industry	Working Capital Expected Frequency 54.7%		Cash Expected Frequency 45.3%	
		No.	%	No.	%
5	Apparel & Other Textile Products	28	80.0	7	20.0
13	Leather & Leather Products	10	76.9	3	23.1
23	Wholesale — Nondurable Goods	26	76.5	8	23.5
27	Eating & Drinking Places	16	72.7	6	27.3
4	Textile Mill Products	23	71.9	9	28.1
2	Oil and Gas Extraction	60	70.5	25	29.5
28	Misc. Retail	21	67.7	10	32.3
21	Misc. Manufacturing Industries	19	65.5	10	34.5
26	Apparel & Accessory Stores	13	65.0	7	35.0
22	Wholesale — Durable Goods	34	64.2	19	35.8
6	Lumber & Wood Products	12	63.2	7	36.8
16	Fabricated Metal Products	37	61.7	23	38.3
29	Others	43	58.9	30	41.1
18	Electric & Electronic Equipment	121	58.5	86	41.5
7	Furniture & Fixtures	7	58.3	5	41.7
9	Printing & Publishing	24	55.8	19	44.2
12	Rubber & Misc. Plastics	23	54.8	19	45.2
19	Transportation Equipment	35	51.5	33	48.5
25	Food Stores	12	50.0	12	50.0
24	General Merchandise Stores	14	50.0	14	50.0
17	Machinery, except Electrical	49	48.5	52	51.5
20	Instruments & Related Products	26	48.2	28	51.8
14	Stone, Clay, and Glass	12	44.4	15	55.6
15	Primary Metal Industries	16	41.0	23	59.0
8	Paper & Allied Products	12	37.5	20	62.5
3	Food & Similar Products	21	36.2	37	63.8
10	Chemicals & Allied Products	36	34.0	70	66.0
11	Petroleum & Coal Products	12	33.3	24	66.7
1	Metal Mining	6	28.6	15	71.4
	Total Sample	768	54.7	636	45.3

Chi-Square 93.24
Significance 0.0000

TABLE 3
Chi-Square Test of Independence
Working Capital Vs. Cash Basis by
Auditing Firm (N = 1,404)

TWO-GROUP CLASSIFICATION

Auditing Firm	Working Capital Expected Frequency 54.7%		Cash Expected Frequency 45.3%	
	No.	%	No.	%
Non-Big Eight	134	75.7	43	24.3
Big Eight	634	51.7	593	48.3
Total Sample	768	54.7	636	45.3

Chi-Square 35.10
Significance 0.0000

NINE-GROUP CLASSIFICATION

Auditing Firm	Working Capital Expected Frequency 54.7%		Cash Expected Frequency 45.3%	
	No.	%	No.	%
1. Non-Big Eight	134	75.7	43	24.3
2. Touche Ross	72	60.5	47	39.5
3. Peat, Marwick, Mitchell	89	58.6	63	41.4
4. Deloitte, Haskins, & Sells	59	58.4	42	41.6
5. Arthur Andersen	133	56.8	101	43.2
6. Arthur Young	54	56.2	42	43.8
7. Coopers & Lybrand	82	50.3	81	49.7
8. Ernst & Whinney	76	41.5	107	58.5
9. Price Waterhouse	69	38.5	110	61.5
Total Sample	768	54.7	636	45.3

Chi-Square 68.06
Significance 0.0000

particular, the smaller the company, the more likely it is that the company uses the working capital basis. For example, while only 18.8% of large companies with at least $2 billion in total assets use the working capital basis, 79.9% of small companies with less than $100 million in total assets use the working capital basis.

This finding was not unexpected in view of the cost hypothesis suggested by recent research by the authors. Given the long history of use of the working capital basis, companies may elect to follow tradition, thereby avoiding the costs of converting to the cash definition of funds. Large companies are expected to have the resources and expertise to switch to the cash basis easily and quickly. Small companies, however, may find the cost of switching to the cash basis too great and not offset by benefits that may be received. Thus, the finding that a high percentage of small companies uses the working capital basis while a high percentage of large companies uses the cash basis was expected.

Industry. A Chi-square test was also performed to test the independence between the definition of funds used and the industry grouping. As can be seen from Table 2, the definition of funds used depends significantly on the industry grouping. Although about 55% of the 1,404 companies in the sample use the working capital basis, the percentage for some industries differs significantly from 55%. For example, 80.0% of companies in the apparel and textile industry and 28.6% of companies in the mining industry use the working capital basis. The following three industries use the working capital basis most: apparel and textile (80.0%), leather (76.9%), and nondurable wholesale (76.5%). Indications are that these industries will be most affected if the Statement of Cash Flows is adopted.

Auditing Firm. The results of the Chi-square test of independence between the basis used and the auditing firm are presented in Table 3. As can be seen, the definition of funds used depends significantly on the auditing firm engaged by the company. For example, while 75.7% of the companies audited by non-Big Eight auditing firms use the working capital basis, only 51.7% of the companies audited by Big Eight auditing firms do so. Further, the percentages differ among the Big Eight auditing firms. In particular, while only 38.5% of the companies audited by Price Waterhouse use the working capital basis, a rather high 60.5% of the companies audited by Touche Ross do so.

In view of these findings, it appears that non-Big Eight auditors will be affected most if the Statement of Cash Flows is adopted. Among the Big Eight auditors, Touche Ross is likely to be affected the most since a large number of its clients still use the working capital basis as compared to the clients of other Big Eight auditors.

Conclusion

The impact of FASB pronouncements is usually not felt uniformly by all companies and all auditing firms. This will be especially true for the proposed "Statement of Cash Flows." The effect of the FASB's expected decision to require a Statement of Cash Flows will be the elimination of the option of reporting funds on a working capital basis. This study reveals that a majority of companies (54.7%) out of the 1,404 in the sample are still using a working capital definition of funds — an indication that the pronouncement will have a significant impact.

More importantly, the findings presented in this paper suggest that the use of the working capital basis is heavily concentrated among a select group of companies. Smaller companies (those less able to absorb the cost of switching to a new reporting basis) are most likely to be currently reporting on a working capital basis. Thus, the adoption of the proposed Statement of Cash Flows will have the greatest impact on these smaller companies. Also, there are certain industries in which the working capital definition prevails, and these industries will be greatly affected. Finally, the results suggest that the impact of the proposed pronouncement will be greatest for non-Big Eight auditing firms because they have the highest proportion of working capital basis clients.

The above pronouncement, if issued, will have a greater impact on some companies and auditing firms than on others.

It appears very likely that companies will soon be presenting a Statement of Cash Flows in place of the presently required Statement of Changes in Financial Position. This will result in the realization of a long-sought goal of the Financial Accounting Standards Board. Expectations are that the change will be an improvement. However, conforming to the proposed pronouncement (including restating prior years' statements to a cash basis for comparative purposes) will present a burden, particularly to those companies and their auditing firms presently reporting on a working capital basis. Ω

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Hian C. Koh, Ph.D., *is a graduate of Virginia Polytechnic Institute and State University and serves on the faculty of the School of Accountancy in Nanyang Technological Institute (Singapore). He has published several articles in journals in the United States, the United Kingdom, and other countries.*

Karen M. Collins, CPA, MBA, *worked in public accounting for several years and taught at Salisbury State College prior to joining the doctoral program at Virginia Polytechnic Institute and State University. She expects to receive her Ph.D. in the spring of 1988.*