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Straight-Through Processing: The Direct Cash Flow Statement -- Finally

By Ann Marie Svoboda, CCM Published: January 7, 2011

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In the October edition of Exchange, the AFP membership was introduced to the Financial Statement Presentation project. The article, presented in the Financial Accounting and Reporting column, explained how the International Accounting Standards Board (IASB), in partnership with the U.S. Financial Accounting Standards Board (FASB), issued a Staff Draft of a pending codification exposure draft designed to change the presentation of today's financial statements. The intention behind this project is to realign the structure of the four standard financial statements to present a consistent picture of information across the face of financial reporting. The result: a revolutionary change for treasury analysis.

Many of the proposed changes are a matter of presentation and categorization and pose minimal controversy. However, there is a material exception. The Financial Statement Presentation includes a requirement to present a direct cash flow statement. This is not just a statement presentation nuance, but a comprehensive change to the methodology for reporting and analyzing cash flow.

The treasury profession cannot ignore this mandate. It has the potential to transform our work. Naturally, transformational change can be a frightening proposition. But this new financial statement could topple the invisible walls that have, until now, commonly separated treasury analysis from the rest of financial theory. This would be a great achievement. Certainly, we might need to toil long hours and incur certain confusion as we implement the new world of direct cash flow reporting. But in the end, the results should prove worth the hardship.

Direct Cash Flow's Impact

Let's first consider the impacts that direct cash flow reporting could have on cash forecasting. In today's world, cash forecasting is an uphill battle. At best, we must struggle to unwind the compilation of operating cash flow, as presented on the indirect cash flow statement, in order to produce numbers that resemble the cash inflows and outflows that we want to forecast and manage. But some of us work for companies whose ERP systems do not automatically produce an indirect cash flow statement. So that set of treasury staff must unwind the timing of accruals between the income statement and balance sheet in order to generate meaningful cash flow information. And then there are those that try to manage cash using EBITDA, a metric that rarely has a direct relationship to available cash flow. Instead, if direct cash flow information is embedded in the structure and functionality of standard financial reporting, treasury obtains an uninterrupted base of historical cash flow information from which to build analytical expectations of future cash activity. To me, that is transformational.

But there is more than cash forecasting to consider. The ancillary components of the Financial Statement Presentation project will add to the transformation, because the presentation and categorization of the direct cash flow statement will align with the corresponding components of the income statement and balance sheet. As such, today's need to infer the relationship of cash flow to other financial information will disappear. Everything will be presented in cohesive and like-for-like line items such that relationships will be defined by the presentation of the statements. This alignment will provide a new dimension from which to analyze earnings and shareholder value.

For instance, the proposed direct cash flow statement will include a line item called "operating cash flow" (OCF). Don't be confused; I am aware that today's standard indirect cash flow statement contains its own line item that is identically labeled. The difference is that the direct cash flow statement's OCF will be the cash-based equivalent to operating income as presented on the income statement. Today's indirect cash flow statement cannot boast this logical presentation.

OCF, as commonly presented on the indirect cash flow statement, includes cash effects of various non-operating items such as interest and income tax. It then excludes cash impacts of capital expenditures and research and development costs. On the other hand, operating income, as commonly presented on the income statement, excludes most interest and income tax impacts, and includes the depreciation charges related to capital expenditures as well as research and development expenses. Therefore, the two operating metrics are not comparable.

The potential ability to associate the accrual-based calculation of operating income with its cash-based equivalent offers invaluable insight to the quality of earnings and, in turn, shareholder value. This is transformational information for treasury.

Within the structure of the Financial Statement Presentation project, the difference between operating income and OCF would represent the influence of timing on economic income. In other words, the distance between the two measures would point to the prevalence of accruals within the operational business model. So an analysis of the variances between operating income and the newly proposed OCF will calculate the standard delay from the point of income recognition to the point of income monetization, which is an invaluable metric for gauging the reliability and quality of earnings.

Greater Visibility

In today's complex corporation, visibility to the reliability of earnings would offer treasurers key insight for strategizing liquidity. In a simple operating model, any timing differences that exist between the cash- and accrual-based earnings measures will eliminate cumulatively over time such that liquidity builds incrementally and is easy to manage. But in the more common, complicated operating model, the reliability of realized income can be less obvious, so liquidity must be closely strategized. If treasurers could easily identify the net timing delays in the realization of income, they could design a more exact, and therefore more efficient, liquidity model.

Insight to the quality of earnings also is advantageous to today's treasurer, because it provides information about capital value. Most shareholders take keen interest not only in the recognition of income, as presented on the income statement, but the availability of the related cash flow. Any perceived delay in the realization of economic income (e.g. the delay in the realization of cash) poses risk to a shareholder's investment. And such perceived incremental risk is then used to discount the value of earnings, which in turn affects the share price. If treasurers could easily identify the inherent risk between the recognition and monetization of earnings, they could delineate and plan for the related impact to their firm's market value.

The introduction of a direct cash flow statement should offer other various and valuable information to treasury. For instance, visibility to foreign exchange transactions might be more easily delineated within the structure of the general ledger. Or the exact cash-based influences of working capital could surface instead of estimates thereof. Or maybe the intra-firm matrix of subsidiary investment and repatriation might find logical representation in financial analysis. The possibilities are endless. The pending availability of a direct cash flow statement will provide the missing link between accounting's standard presentation of the company's earnings and treasury's need to manage the company's value. Through the direct cash flow statement, the IASB and FASB pose a logical solution to what is today a murky gap of information. It is a bold request—and likely will take material effort to achieve. But it is a valid and much needed change to financial reporting that will garner invaluable information, and undeniable transformation, for treasury.

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