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by
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Professor Bernstein:
Good evening ladies and gentlemen. Welcome to the 31st Emanuel Saxe distinguished accounting lecture. I'm Leo Bernstein, Professor in the Department of Accountancy. As you probably know, this lecture series was established in honor of our Dean and Professor Emeritus Emanuel Saxe who we are pleased to have here tonight. And we are very fortunate to have this evening with us Mr. Michael Bohan, Director of Accounting and Auditing Standards of the Firm of Touche Ross & Co. Mr. Bohan is very active in professional societies and committees as the announcement which you have received details. He is also particularly relevant to this topic tonight as a member of the FASB task force on reporting income cash inflows and financial position of enterprises. The topic of cash flow has very much been in the forefront of current professional discussion, not only because it always recurs in times of economic stringency, in which we are, but also because it has particularly arisen now in the context of the conceptual framework which the FASB is working on. We are fortunate to have someone who will bring us both an up to date and expert viewpoint on this important topic.

Mr. Bohan: This evening I am going to talk to you about reporting funds flow and income. My talk will center around the FASB project on reporting income, cash flow and financial position of business enterprises. I've captioned this topic "Cash Flow Reporting: An Innovation or a Return to the Beginning?" I'm not really going to answer that question. However, I want you to reflect on this throughout the presentation. Are we really doing something new or are we going back to something close to cash basis accounting with perhaps a different presentation format? About 20 years ago, when I was just finishing my first course in accounting, I went over to the west side of Chicago where my father ran a bar. That is what all good Irishmen seem to do if they are not cops. I went behind the bar and he said, every time you come home from college I have to give you a refresher course on how to run the cash register. He implied I was untrainable and some say that I still am. When I got behind the bar and as I was working with the machine I noticed right next to it there was a stack of bills for customers. I said, "gee, what are these," and my dad said, "tabs I've taken on the cuff from some of our customers." "Well, have you rung them up yet, dad," and he said "no." I knew what accrual accounting was, but he wasn't quite up to that. He said that he hadn't rung them up and I said, "why don't you, dad." He said, "those don't pay for college, it is the money in the register that does." So my father may have been 20 years ahead of the profession at that time. I'm not sure.

Well why don't you reflect on whether we are really doing something new or reassessing what we have and perhaps moving away from some of our exotic accrual accounting. The presentation is going to center on two items that came from the FASB in addition to the exposure draft. One is the discussion memorandum entitled "Reporting Earnings" that came out in July of 1979. The other is the discussion memorandum on reporting funds flow, liquidity and financial flexibility that came out in December 1980 with the current exposure draft coming out last November. In fact, today, May 3, is the end of the comment period for that exposure draft. There was one other document that was covered as part of this project. An invitation to comment on that came out in May 1980. That document was meant to address what should be included in the financial statements, outside of the financial statements, and to some extent address the question of whether accounting measurement and presentation should be the same for large companies and small companies. That has mostly been embraced now in the FASB project on reporting for privately held and small public companies -- another document for which the comment period ends in about another month. The Board has just about overwhelmed us in the last six months with exposure drafts. They have issued more documents than the Book of the Month Club has, at least recently. You certainly will have a lot of new things to consider when you get out and practice, for those of you who are not there already. Throughout the presentation I will try to interject the flavor of written responses to the FASB's discussion memorandum; comments that were made at the public hearings; and comments that the Board and staff have made at various public meetings of the FASB on this topic.

To give you an idea of the approach I am going to take, I am going to give you the historical background on what has happened. I am going to discuss the reasons for the FASB's project and the primary questions they have asked with respect to funds flow reporting and income reporting. I'll review some of the formats they are considering for financial statement presentation; talk about some of the additional items, questions and possibilities of reporting they have considered; and I will briefly and very briefly touch on inflation accounting. I am going to mention the new areas of liquidity and financial flexibility that really popped up in this project; summarize the exposure draft; and, finally, give you an idea where the Board may go in this project. I saw a comment in yesterday's newspaper in the magazine section that said everybody seems to know what an Irishman is going to say but not how long it is going to take him to say it. We will find out if that is true today, but I am going to try to restrict this to approximately an hour.

A summary of recent history, if you will allow me 20 years for recent history, follows. In 1963 the Accounting Principles Board ("APB") issued opinion number 3 and that was more of an exhortation than a requirement. It said reporting funds flow is nice. Reporting the sources and uses of funds is nice. It was not a requirement. It just said that it was interesting information and it would be nice if companies provided it. Then in 1969 the SEC required that public companies include a statement of source and use of funds in annual reports. In 1971, the APB issued statement #19. This went from the exhortation of APB #3 to a mandatory provision that a statement of changes in financial position be presented each time an income statement is presented. They fancied up the words -- went from the term "source and use of funds," which some detractors in those days used to call the "source and useless," to a statement of changes in financial position. A little more catchy title.

In 1973 the SEC issued ASR 142. Now 142 prohibited public companies from including in their annual report to shareholders, either in their financial section, operating section, summary of operations, or president's letter, the presentation of cash flow per share. That was quite a popular disclosure coming out of the go-go-years in the 60's. Some people felt it gave a better presentation of the cash generation abilities of an enterprise. The SEC appeared to be concerned, while they didn't mention any specific industry, with those industries that generated heavy front-end cash. For instance, a service industry that charges an initial fee and does not have an immediate outflow of cash because its obligation to provide the services and the cash needed to provide those services to cover that obligation would not go out for one, two or three years hence. So these companies were able to show a higher cash flow per share than their earnings per share. Other industries experienced a similar situation, so they effectively said we don't want you providing cash flow per share. For one thing it appears to compete with earnings per share which is a measurement of operating performance and we think cash flow is inappropriate.

There were a number of companies which took this presumption to heart. One in particular, a New York stock exchange company, said we really want to present this, but we know the government won't let us do this so the next slide is going to be an extract from a summary of operations from this company's

1979 annual report to shareholders. It is just 3 columns from a ten-year summary of operations. I know they reported this way in 1980. In 1981 I am not sure but I presume they continued to do so. You'll notice they presented a line or section entitled cash generated from operations or by operations. They have an amount line and immediately below that they have a blank line with a footnote. In case you can't read the footnote I will read it for you. "The Securities and Exchange Commission has determined by edict binding upon all listed companies that stockholders are apt to be mislead or become confused if figures are published showing cash generated per share. Since many analysts and stockholders view cash generated per share as a significant piece of information, we have complied with the edict of our federal government but provided suitable spaces above where interested persons may enter the prohibited figures."

They managed to work their way around it a little bit. I have fantasized about it. Gee, if they could get the company that prints the instant lottery tickets they could say "scratch here to get the cash flow per share number." It would have saved their stockholders the trouble of calculating it. Here is at least one company who objected to the SEC position. When Harold Williams was chairman of the SEC he indicated some inclination to revoke ASR 142 and permit cash flow per share presentation. However, that did not take place. In a recent conversation with representation of the Chief Accountant's office of the SEC, we were told that they would continue to prohibit presentation of cash per share numbers, other than dividends per share.

So much for 1972. Then we sort of sat back without a lot of activity except for some rumblings of the FASB and the Objectives Committee's proceedings about the importance of cash flow information. They formed a task force to study it. And while the task force was diligently studying this in 1981, the SEC revised its 10-Q, that is a company's quarterly report to the SEC which is often identical to the quarterly report to shareholders. It was revised to require the presentation of a condensed statement of changes in financial position. Prior to that release, quarterly reports did not always contain a statement of changes in financial position. The preparers argued that the 10-Q did not contain a full statement of earnings; therefore a statement in changes in financial position was not needed. The new rule eliminated that one problem. In 1981 the FASB issued its exposure draft. I am here to discuss that today. Also, within a month of its issue, the Financial Executive Institute issued a document. I call it a response. It was actually an alert to their members saying that they believe cash is the right approach to use for the statement of changes in financial position. The preponderance of practice prior to that had been to use the working capital approach. A little later on when I talk about what's happening I will give you some statistics on that.

The last thing that has happened of late, I believe it was in March, was that the Auditing Standards Board of the American Institute of Certified Public Accountants issued an exposure draft of a Statement of Auditing Standards regarding reporting on changes from a statement of financial position from the working capital format to a cash format. The present auditing literature includes in the section regarding consistency a provision that a change from working capital to cash or vice versa would require qualifications in the accountant's report. Many accountants have read this to apply only when the change resulted in or had a material impact. That was defined as when working capital showed a decrease but cash went up so they went to the cash approach... I'm sure others used different measurements. This document proposes that a change from one approach, working capital to cash or cash to working capital, should not be viewed as an accounting change and not be mentioned in the accountant's report. It is part of an omnibus exposure draft. I think this part will pass rather easily. It makes it easier for the members of the Financial Executive Institute to adopt the cash approach without cluttering up their accountant's report.

So much for history. Why did the FASB go into this project and what are some of the reasons? I am going to stress throughout my presentation the cash flow, the funds flow part, and only incidentally the earnings part. So you will forgive me if it seems that I have put that aside, but I want to stress the cash flow part. There were three main reasons for going into this project. An increased interest or renewed interest in funds; defects in the existing reporting approach; and the conceptual framework project. I will cover each one of those individually. First, the question of an increased interest in information about funds flow. Well, there has been a declining focus on income. If you remember, ARB 43 talks about the prominence of the income statement versus the balance sheet. We are now facing a recession with cash flow becoming a critical point in the operations of the company. We don't just report earnings now. We really have to have the cash to survive, not just to foster operations, but to survive. It was also thought that more information was needed on funds flows regarding investing activities, financing activities, liquidity, flexibility -- all elements of cash flow.

The second reason for increased interest was this question of quality of earnings. The time lapse between income and cash flow. How soon do reported revenues turn into cash? Do they operate it immediately, as they generally do for a retailer who sells for cash? Or is it over some extended period of time, as is the case with many real estate enterprises which, at least at one point, reported a heck of a lot of income at the front end and then had to wait a long time, if ever, to collect their cash. The question of quality of earnings has forced people to look more at cash flow. There is also the question of changing prices, again a quality of earnings question. If I report a lot of income today, but I am not going to collect it for three or four years or some extended period of time, how much will those bucks be worth when I finally collect it. Will I be able to sustain my operating plant or will the cash collected be worth so little I'm going to have to go to outside sources to continue my operations. So the whole question of timing cash flows brought about this increased interest.

The final reason is the problem of the deterioration of traditional indicators of liquidity. For years credit grantors had looked to the current ratio, current assets, current liabilities and the quick ratio, that is the current assets except for inventories, basically the monetary current assets compared to current liabilities. They looked to those as indicators of liquidity and stability of a company. Well, from 1947 to 1979 the current ratio dropped from 2.67:1 to 1.71: 1. The quick ratio dropped from 1.39:1 to .85:1. So we have had a significant decrease in both of these ratios. Now in part the decrease is due to a change in the way people are doing business. There are improved management skills in controlling inventory levels, cash, and payables. People are smarter at managing their cash. That may be part of the reason for this. Another reason for the change is accounting changes that have taken place in the last 10 years. For instance, changes to LIFO have reduced the inventory amount shown and have only approximately a halving effect or 50% impact on the liability for income taxes. So we have had a decrease in the current asset side and a net decrease in working capital for those companies that have adopted LIFO. We have also had a decrease because of reporting lease transactions under statement #13. We wind up recording an obligation and that obligation is broken up between current and noncurrent. The current portion adds to the current liabilities and reduces working capital. Recently the FASB issued a new standard on compensated absences, requiring the recording of vacation pay. Again, a new liability accrues which will sock into this ratio. Now, that is not reflected in my statistics because that is a current year statistic. I am not sure there has been any further erosion as a result of this.

In addition to the accounting changes and the management improvements, there definitely has been some change in just the way people are financing their business. There has been an increased use of short term financing versus long term financing and a decline in the proportion of financing that is provided internally. The ratio of long term debt to short term debt dropped from 3.5:1 to 2.6:1 from 1965 to 1979. In that same period the percent of cash from operations as a percent of total sources of funds dropped from 56% to 42%. Debt increased as a source of funds from 26% to 35%. Companies are being forced from equity financing because equity markets are not appealing. They are being hurt by the high interest rates eroding their earnings. So much for the increased interest in funds flow. Now for the defects in existing reporting.

APB #19, while a nice statement, at least to those who like the changes in financial position approach, had one significant flaw. It gave you a multiple choice on how to present funds flow. You could choose cash, you could choose working capital, or you could pick whatever was behind doors one, two or three, if you were innovative enough to come up with another approach. Some firms used what I call net monetary assets or liabilities. They took the monetary side of the balance sheet and deducted the liability side, similar to the components of the quick ratio. I believe F.W. Woolworth uses an approach which offsets certain liabilities in coming to the number it describes as funds. So we had no single definition of funds. This resulted in a lack of comparability. The cash flow approach was not required. You could do something other than cash flow. In the period 1977 to 1980 the preponderance of companies used the working capital approach. This is from Trend and Techniques. Firms using the cash approach went from approximately 5% in 1977 to about 10% in 1980. I am going to predict that the Financial Executives Institute notification will result in an increase of this to somewhere around 50% this year. I'm not sure, but just from everything I have heard and with the change in the impact on the accountant's report, I would say there will be a significant increase in the number of firms going to changes in cash. This is especially true since the FASB is in support of the cash approach as well.

Let's go back to the remaining defects in the reporting system. Many say the present statement is not meaningful since it is merely a listing of sources and uses without trying to gather them in a meaningful way, with the possible exception of operations, and many have a concern with the way operations are presented. There is no real distinction in operating performance. It does segregate earnings from continuing operations, if you have a discontinued operation. In those cases where you don't have a discontinued operation, you could wind up with all incidental items included in net income and have this marvelous accountant's dream of a reconciliation coming down to funds provided from operations. Many feel there should be some way of isolating operating performance and maybe even handling those problems where you have a significant discontinuance of something that is not a segment but is part of a segment. For instance, A&P had a significant drawback from given geographic areas. That did not constitute a segment under APB Opinion #30 so they could not treat it as a discontinued segment. Yet they really withdrew from an area. How could they better portray the impact on their cash flow from pulling out of that area. They did it by a multiple column approach, at least in the earning statement. You might want to see what they did with the cash flow statement. I can't recall if they continued the multiple column there or not.

There also is the question of the need for more information regarding financial flexibility and liquidity. We have some information, but could more be provided? The concern is that we don't have sufficient information presently.

And finally, a classified balance sheet is not required. Some would say it is a bad thing. Our problem with both the need for more information on flexibility and liquidity, in particular liquidity, and the question of the classified balance sheet, I think, is somewhat caused by the provision of ARB 43 as it relates to working capital. Normally you consider working capital as being assets maturing or to be converted to cash within one year and liabilities to be liquidated within one year. However, there is the provision that says some businesses have an extended operating cycle and therefore can consider as current assets and liabilities those items that turn into cash, or mature as cash obligations, in the normal operation cycle. It is assumed that everybody is going to be very evenhanded about determining what their operating cycle is. The operating cycle is very popular, especially for construction contractors who want to have a classified balance sheet. Their credit grantors like them to have a classified balance sheet so they can figure some wonderful ratios. It is my belief that construction contractors generally consider their operating cycle to be the length of their longest contract and accordingly just about everything goes in current assets except for some property plant and equipment that can be used repeatedly in contracts. Now on the liability side they seem to be a little more precise. While it is not generally true in practice, I am acquainted with at least one organization that has permitted the liabilities for a contractor to be determined on a one year basis instead of on an operating cycle basis while using the operating cycle for the classification of assets. So you wind up with what I call a nonsymmetrical classification approach.

The whole problem of what constitutes a current asset and a current liability and the ability to use the operating cycle approach has deterred any meaningful information from being obtained from the working capital ratio. It seems to me if we are going to preserve working capital we might as well have a clean one year cut off. That may give us more information on liquidity and flexibility. Let those other specialized industries provide additional information if they want to zero in on their operating cycle, but let's have some uniform comparison approach.

The last of the three main reasons is the fact that this is an integral part of a conceptual framework project. In Statement of Financial Accounting Concepts A, Objectives of Financial Reporting by Business Enterprises, it was concluded that investors, creditors and others require information about resources, claims to resources and changes in resources to help them assess future cash flows. As a result of that, the Board has, just by making that one assertion, made funds flow an integral part of the conceptual framework. And once they have it in there, they have got to determine how to present it. You have to remember that this exposure draft is basically a display document in the conceptual framework process. Others are measurement documents. This is one of presentation, of display.

Let's look over some of the questions that the Board asked in its discussion memorandum. They asked if the funds statement was necessary. I already told you that they said that cash flow is important so they had that one answered before the document went out. But you have to remember, the Board has to ask all the questions in the world in the discussion memorandums to satisfy their due process procedures. It is almost like Johnny Carson and Ed McMahon working together at times because they really get down to some minutiae in questioning things. One question is "Do we really need the statement?" Of course we do. Second thing, "Does it apply to all industries?" While manufacturing companies and retailers had been supporting, or at least going along with the statement, the financial institutions (banks, savings and loans, and insurance companies) had been objecting to it. They said, "gee, our income statement is significantly cash oriented anyway and we think this statement is not meaningful for us. We don't think we should present it." Well, perhaps they have to take a different approach in the way they format their statement, but it seems to me that funds flow is awfully important to those folks, as we have seen many banks and savings and loans forced to merge of late because of cash/income problems. They can't ignore their liquidity and flexibility problems and they all relate to cash flow. So I believe Board will require statements for all industries. They may allow some latitude in how they approach it.

The Board also asked, should we have a variety of definitions of funds as we did in statement #19 or should we lock in on one approach? Do we use cash, working capital or what have you? The Board has concluded that cash is the appropriate approach. Now I am waiting for them to define cash because in the last couple of years I have seen more innovative things done with cash than I can believe. You will find the report has shown that a number of companies have a new item that appears on the credit side of the balance sheet. The item is entitled "checks outstanding." Now your question should be are those checks really outstanding or is that a neat title to cover an overdraft? In most cases it is an innocuous way of describing it. Other situations are money market funds and cash equivalents. Can they be included in cash? What do you do when you have an overdraft in some bank accounts but not in others? Can you offset it or do you have to show all overdrafts on the liability side? Nothing in the authoritative literature addresses cash. There are a lot of problems presently in practice regarding what constitutes cash. So the Board, when it comes out with a final standard, will have to address that. But they have said cash is the number they want.

The next question is, "what do we do with nonfund transactions?" For example, when you issue debt for the acquisition of a company. You have never put cash out. Should that go on your statement or not? What about when you issue stock to retire debt? Should that go on this funds flow statement or should that go elsewhere? The Board has raised the question and I am sure they are going to want some broad presentation of this, but it has not been resolved as yet.

With respect to reporting earnings, they have asked a number of additional questions. How should we handle infrequent activities? Should we have some format in our statements to cover infrequent activities versus continuing? How about activities that are incidental to the main business? They may not be infrequent, but they may not be the main operation. For example, financing operations or the sale of scrap as a part of cost of sales. Where should these kinds of things be treated? Should we have some special approach for allocations to show just what parts of our financial statements are a result of these allocations? Remember the problems we are going to have there. Inventories are an allocation. It is going to be pretty hard to describe all the components of inventories. Should we have some special treatment for accounting changes? Presently, except for those accounting changes mandated by current literature and a couple of exceptions, all accounting changes are picked up by a cumulative effect adjustment. The Board has tentatively concluded in its exposure draft that retroactive adjustment is the way to go for accounting changes.

The final question they ask regarding the earnings statement is, should we have earnings forecasts? And there the FASB said, "Gee, those would be neat but we don't want to touch that right now. We will wait and see what happens." So while they think earnings forecast might be meaningful, they are not ready to take the big step.

They have also addressed the additional conceptual question of "Once we decide everything, how are we going to present this stuff?. What sort of alternatives do we have? What sort of line items are we going to present and how should we handle reporting operations?" This part of the presentation is somewhat going to blend these items together so bear with me because they are interactive. Let's start with the middle one, criteria for line items. The answer is easy. It is anything that has a material bearing on the financial statements to understand funds flow or earnings. But we have always had the problem of what is material. Probably, in addition to a measurement based on earnings we have to look at something like the percentage impact on total funds provided or used; perhaps a trend of the given item on the sources and uses of funds over a given period of time presented. In terms of alternatives presented, we have our traditional approach to the statement of changes in financial position, the source and use section. The source part picks up operations and other sources. The uses part picks up how we expend our funds. You will excuse me for using working capital here, but it is tradition so I am going to pick up working capital. Unfortunately, I think my next slide is working capital too, but I haven't got an excuse for that yet. But the basic approach was that of the accountant's dream. You just take the differences in the balance sheet and plug it in with a few items grossed up. The Board and many of the respondents said maybe we should do something a little differently. Maybe we should break up our funds flow statement into more meaningful components. Operating activities, which would be your operations section similar to your net income section but maybe a different way of addressing it. Let me keep how we are going to do operations to the side for a moment. I am just going to tell you that three basic components, operating, investing and financing activities, would at least give more meaning to the statement than showing all the ways it came in and all the ways it went out any homogenous grouping. Included in property might be equity investments of some sort. Financing activities would recognize receipt and payment of various debt and equity items. Now here is a question, does a change in accounts payable represent financing activities or operating activities? I think some of these questions arc going to be settled on some arbitrary convention basis. Just a practical definition and then they will move ahead rather than go through any multiple choice for a given company. The Board has proposed, and in their document they support, some way of segmenting the fund statement. Be it in one statement of all three pieces or three statements, one for operating activity, one for investing activity and one for financing activity. Now they haven't said this is the only way to go but certainly in this exposure draft they are supporting some fracturing of the statement into meaningful components.

Now let's look at net income for a minute. There is an alternative to the reporting of operations. The accountant's dream approach is when we take net income and we start adjusting it for depreciation. Have you ever heard these guys say "Boy I got a lot of funds this year from depreciation." I was sure we had gotten over that 20 years ago but one of the executives from an investment banking firm said, "What are we going to do about all this depreciation that provides funds?" I couldn't believe I heard it at that point. But some folks still believe it. Anyway, we have the accountant's dream, the reconciliation where you add back all these items that are nicely reconciled. But does it really tell anything versus some approach that grosses up the income or operating activity such as gross collections from customers and payments to suppliers. This can be simply determined with a few conventions applied to the basic financial statement. You don't have to keep records of payments to all suppliers. You can adjust your sales by the changes in receivable to come up with the gross numbers, the broad presentation. The Board has not spoken in favor of either of these as yet and there was mixed support for the gross presentation during the comment period.

In addition to the format question they asked whether there are other things that can be presented regarding funds flow. Should we present the information regarding the payment for purchases of fixed assets? How many of the payments or how much of the payment were made to maintain operating capacity or to maintain existing production capacity versus how much of the expenditures represented an expansion of productive capacity? Now those are really neat pieces of information, but I can assure you those are hard things to measure and even harder to audit. I doubt the Board is going to require a presentation like that. However, they are probably going to tell people, "If you think you can do it, go ahead, but please put it outside the financial statements." Another item is conformance to Environmental Protection Agency requirements. Perhaps to the extent it can be identified, disclose how much you expend on that. Companies really like to do that because they talk about the overload of governmental requirements. They may tend to overload the amount they present though. And finally, nonoperating expenditures and investment activities, for instance, the investment in an entity that would not be accounted for under the equity method but would just be some passive investment. Break them down into little pieces. Perhaps give funds flow information on a segment basis similar to what we do for operating income for the moment. That may be pretty tough because once you get below the operating income line, if not before, there are a lot of allocations between the components of a business enterprise. I have a feeling the Board will not pursue this one, at least at this time. They suggest disclosure of restrictions within a group. In other words, a bank holding company can't just suck all the funds out of its wholly -- owned subsidiary bank. There are regulatory restrictions on that. These should be disclosed in some fashion.

Perhaps there should be disclosure of summary indicators in addition to earnings per share. Maybe return on investment or some presentation like that. The investment analysts who are on the FASB task force with me seemed opposed to this. I got the idea that they felt we were taking away their prerogatives of making these magic calculations. Seriously, they had a good point that people may think that these are the only indicators to use. There is such a variety of things we consider why don't we just make sure the necessary basic information is there, but just not make the calculations similar to the company that left the space to drop the numbers in.

And the final question is, should the statement be cumulative or comparative? I can't believe we are going to have a cumulative statement of changes in financial position. It seems a year-to-year comparison is the most meaningful.

The FASB briefly mentioned, and I said I would briefly mention here, the question of changing prices and inflation accounting. The Board asked, "should we provide some measurement of information regarding cash flows on an adjusted basis to help people to project what is going to happen with inflation or what may have affected a company's ability to use funds because of past inflation? But they said, "We are three years into our five year experiment, let's not do it yet. Let's wait until we finish our five year experiment before we start messing with cash flows and trying to somehow integrate that into the overall inflation accounting model." I have a feeling there is some lack of knowledge on how to do it and I share that lack of knowledge at the moment. I think that they want to see what companies have done in the five years for internal purposes and maybe they can build something out of that.

Now, the Board also addresses the topics of liquidity and financial flexibility. They got into this as sort of a natural extension of its funds flow project because current and no prospective funds flows depend on the flexibility of a company. That is, the ability of a company to cause a change in cash flows. It relates to the adaptability of an enterprise. Liquidity relates to how quickly changes can be made to convert to cash. Liquidity represents the nearness to cash. In these two areas, the Board discussed the possibility of having some additional subtotals in the balance sheet. For instance, a quick asset subtotal before coming to the working capital subtotal. They thought that they then would have to wrestle with the definition of what items would have to go into the various categories. Then they talked about other information that could be provided on an off balance sheet basis and really blend in flexibility and liquidity together there. For instance, information about maturities of obligations and maturities of assets. In terms of financial flexibility they suggested that certain other disclosures should be considered: Ratings of commercial paper, bonds, preferred stock; the amount of unused lines of credit, restrictions in the sale of assets and other financing agreements that may currently be in place but not yet taken down and the market value of nonoperating assets (which was pretty much booed down during the discussion memorandum period and I don't think it has raised its head since). They also suggested some information about the separability of assets. This is really covered at the moment in the segment information portion, statement #14. Then perhaps a segregation of discretionary and nondiscretionary expenses.

Now in the exposure draft, in addition to liquidity and flexibility, they got into a range of other topics. I am not sure they reached a conclusion on any of these, but they seem to give a paragraph or two of a lot of the "Gee it would be nice if you could do something that would help investors determine their return on investment." However, if you look at what they discussed, it sounds like something out of a finance course where you don't really do anything directly from the financial statement information, you do it based on the market price and the dividends paid on the stock. The enterprise's return is a return on investment concept. There they don't describe how you are going to measure the denominator in the calculations. So one would think that perhaps because we are in the historical cost context, we continue to use historical cost as the basis. But with their inflation approach in statement #33 maybe they want this return measured on some current cost basis. But they haven't really cleared that up either. They are basically taking a capital maintenance financial capital approach where you use capital not in terms of maintaining your physical capabilities of producing but maintaining a given dollar amount of capital from beginning to end of the year. That's exactly what we do presently in historical cost accounting to measure income.

They coined the phrase comprehensive income with the elements Concept Statement. As I describe it "incomprehensible income" because we now no longer have the number that comes off the earnings statement as earnings. We have at least one item that is sort of tucked away in equity as a result of statement *#52 on foreign currency. That is the translation effect. I don't know how everybody describes it here, but we talk about it as dangling in equity and there was a typographical error in one slide and it said "danger in equity. " I think it might have been more correct in that slide than what we call it. We now have numbers that measure comprehensive income. Not just in the income statement but in an equity statement as well. There are some real problems with statement #52* in this area that I am not intending to get into here.

They also say, "wouldn't it be nice if we could tell investors something about the risks of operating the business." The risks they are talking about disclosing are liquidity related -- maturities of liabilities and timing of maturities of liabilities compared to timing of maturities of assets are examples of these disclosures. Operating capability ties into the capital maintenance area. And finally, they say again that this is part of the conceptual framework project. But you know they have some more things to do in that project before they really come out with anything that you are going to be able to use for financial reporting. They have to tell you when to recognize assets and liabilities in your financial statements.

The main message when you get through reading the exposure draft is the Board's view that the parts are more useful than the whole. In other words, don't concentrate on earnings, don't concentrate on net worth. Go through the statements picking out those pieces that best describe what's going on in the business -- see how much of the business is dependent on something other than its main source of business. How liquid is the business? Don't just look at a couple of numbers, take a look at the individual pieces of the statements. Which seems contrary to what the auditors do. We always talk about the statements taken as a whole. Somehow we have to make sure that these parts that are contained in the whole are at least reasonable representations of what they are put forth to be.

Well, what will this project add? It will facilitate an evaluation of overall financial performance.

Especially if everything they mention is incorporated. Hopefully, it will result in meaningful disclosure of the components of cash flow. The three phase rather than the source and use approach that I described incorporates the concepts of liquidity and flexibility in reporting and perhaps will result in more information in statements that will allow us to assess this. It requires or leads one to believe there should be homogeneous components in the statements. In other words, similar items will be grouped in similar places rather than spread around like peanut butter in the financial statements. Especially as they are now using the source and use statement format. And finally, it will be a contribution to the overall objectives project -- as long as the remaining pieces of the project give sufficient direction.

As before, I said, the FASB has identified what an asset and liability are. We talked about how the FASB believes those items should be presented in the statements in this document. But the FASB hasn't said when you report an asset or liability. This is part of the recognition project. We are expecting a document momentarily from the Board on that. But still they are only leading in to their initial external consideration of recognition. And once we have recognition, they have one more major project to get out of the way, and that is measurement. Do we retain the historical cost context or do we go to some value approach other than historical cost?

This document, in final form, will make a contribution but it will be similar to the other concept statements that are motherhood statements. It is hard to refute what they say as being meaningful information, but the problem is trying to see how we can pull this together into standards. Your reporting is not really going to change until the FASB amends APB #19, APB #9. I think there must be one or two sentences left in that. They say they amended that on a piecemeal basis with APB #30.

On this timetable, they hope to get a final statement of concepts out by the end of this year on this topic. But they still have the remaining projects of recognition and measurement before them. Then they have the total standards revision before them before we really see how this is all going to pull together.

This is the end of the formal presentation. I guess I am ready to be roasted.

Question:
Since no one else will speak up supposing I lead off first with a brief observation, Mr. Bohan. As I was listening to your detailed presentation and reflecting on the details in the exposure draft, I was led to thinking that if any governmental agency were to think of promulgating a rule which would require this kind of elaborate detail I am certain that the private sector of our nation would rise up to a person and say is this a totalitarian or authoritarian government that is confronting us. To my mind, and it ties in with my first observation. I find this, not your presentation which was very interesting which I expect from an Irish leprechaun, but the presentation from the FASB -- I personally find rather insulting to those of us who have committed our intellect to the advancement of the accounting profession and to those of us engaged in practice trying with all of our might in a particular case to present the information meaningfully so that those who have a right to know will be able to make those interpretations and those determinations that are appropriate for their decision making. For them to try to say in some kind of general context this is what it is that you are going to do and this is the format. The next thing they are going to tell me is the size of the paper and the kind of type that I am going to be using. But now a very pure and really true question. The thrust here is more and more towards your Dad's concept of cash, possibly because of the disenchantment of the accrual basis. But ironically, when I attend meetings of the governmental accounting standards groups, the thrust is 180 degrees away. They have been told or lulled into believing that you have to go away from the cash basis which was traditional with governmental accounting into the accrual basis. Now can you reconcile the two excepting for the fact that the accounting profession is trying to sell government a bill of goods.

Answer:
Yes, I can try. I stress the funds flow here but in the exposure draft the Board states that really funds flow would not take a premiere position over reporting income but that they should be complementary. Reporting income is somewhat like we have known in the past. It helps measure current operating

efficiency. But to complement that with the funds flow side to see your cash generating abilities and your ability to continue to finance the business. I'm sorry, because I'm sure I seemed to stress funds flow so much I dropped income completely off the deck here. It really is intended to be a complementary approach. To bring back some prominence to funds flow reporting but not to remove the earning statement as a primary statement.

In terms of the governmental units, boy that is a touchy area anyway. We don't even know who is going to be setting standards, but I think we have a whole bunch of people lined up to start to do it. They have been primarily a cash basis operation. There has been some concern that perhaps they have significant obligations that haven't been recorded. That there should again be some complementary reporting to see how they are operating not just how they have been able to survive by providing more cash than the current outflow. Corporations have the same problems with pensions. There are a few unrecorded obligations that we are wrestling with here. If you follow the pension project it looks like the Board will require recording of an obligation for all, not just vested benefits but the benefits under statement #35, of which I can't think of the description at the moment, but anyway, all accrue benefits I think is the term. They don't know what to do with the debit once they record the credit. They talked about letting it sit on the balance sheet as an asset. Debit goodwill or maybe "badwill." They talked about putting it in equity, but that is getting a little crowded right now. We have a number of things dangling in equity for the moment. So they are really facing a hard one. I don't know if I have answered you entirely but it is meant to be a complementary approach to the two statements.

Question:
We are all in agreement that the income is not going to be eclipsed here, but in reporting sources of cash from operations which as you said the FEI is so much encouraging, assuming even a number of their members are going to adhere to this, do you think we are going to get cash from operations out of this? Aren't there now a great many statements which call themselves statements on a cash focus but when you go to the operating section all you find is what you find in the working capital focus statement mainly an add back for depreciation, maybe some deferred taxes. That is what they call sources. They don't specify cash. Isn't this really a critical area which the Board has to address?

Answer:
Sure. You are talking about the fact that they are not considering all collections from customers. Which would involve the adjustment of the current assets and liabilities.

Question:
Now also on this same subject. Isn't operations itself a matter of definition? For example: If you buy a patent and decide to expense it immediately. That is an expense. But if you buy a patent and amortize it over 14 years that is another application of funds, isn't it? What do you think should be done in this area?

Answer:
I think what they call operations or what they call cash generated from operations should reflect, and I am going to make it sound like a reconciliation approach for the moment, but I think the operations should reflect the transactions with customers of cash generating transactions which means you would move the changes to receivables to operations. You would move the changes in payables to operations. The changes to inventories would be an adjustment to cost of sales. Then you would have the question, what is an allocation to which you might want to play with a little bit. It seems to me that only the items which are only true financing activities -- Commercial paper, not payables, long term debt, equity issuances, retirements of debt should be down in the financing activity area. In the investing area I would include property, plant and equipment acquisitions. But I have to think about that one a little bit. That may be where I am getting the trouble, by playing with that, because perhaps I should be charging operations and some of my replenishment of capital plant. I haven't figured out what I want to do with that yet. Do you have an idea how you want to do it?

Question:
I saw Digital Equipment this year deduct the entire acquisition of plant and equipment from funds from operations. Even though this represented a 40% increase in other fixed assets. That is a very conservative approach but it points up the fact that there is no uniformity here at all.

Answer:
The statement is so broad right now. They talk about leaving it open for a variety of approaches and we won't know until we come out with a standard if they are really going to tighten it up or if we are going to have some broad guidance. You have to even define cash, as I mentioned earlier, and then how you are going to take care of all these other activities of a business to measure cash generated from operations will take careful work on the part of the Board. I think they must give some arbitrary direction so that everybody does it the same if that is their goal. They are either going to tell you to treat all investments in plant as a reduction of cash from operations or they are going to treat it as investment activity. They are just going to have to make some arbitrary decisions.

Question:
I realize that this is a statement of accounting concepts rather than a statement of accounting standards, so I see that the Board did not come up with any examples with figures to show us what is the real contribution of this, because, as I see it, it is nothing more than reclassification of the item that originally appeared on the statement of changes in financial position. Had there been an example with figures to tell us this is the real contribution of this. That everyone now cannot do it himself. It could have been easier to understand the real contribution other than some additional disclosure.

Answer:
In the discussion memorandum they had a variety of examples. As a matter of fact, they worked off the same trial balance or the same basis balance sheet and then showed you a variety of ways they would do it. They didn't carry it over to the concept statement draft and when I was going through the index before I read the concept statement I saw a couple of things that said "example of" and I said "Oh boy an example of." Unfortunately, there wasn't an example. There were some words there describing it, but there wasn't the nice picture you could look at. They have continued their approach in the concept statement draft of not giving any pictures, any formats, any graphics. However, in the discussion memorandum on this I was the one that suggested they do work from a standard balance sheet and then show the variety of ways they are considering; so that when people addressed this they could work from some hard data and they could massage it anyway they wanted to come up with their idea how the statements would look. My firm had one way of doing it. Each firm seemed to have a little different approach. But they did seem to work off of that example. And if you want to look at a variety of ways people might do this statement, go to the FASB or American Institute, it is on microfiche. Look at the response letters and you will probably see some approaches you never even thought were ways of presenting a statement of changes in financial position. Yes, it is hard to grasp when you read this document.

Question:
Unrelated to the previous items, Mr. Bohan -- obviously, all of this is intended to help to fulfill the objective that you cited, namely to give the users of financial statements an idea of the amount, timing and uncertainty of future cash flows. The question comes to my mind regularly, Mr. Bohan, assuming that this is a fair objective and assuming that the users do in fact have a fair entitlement to this information and a fair need for it -- In view of the fact that corporate managements are either the agents or the stewards -- Hence for all intents and purposes the employees are the users of the financial statement -- Query, why not say to corporate management, make public your cash budgets, your capital budgets and your operating budgets. In that way then we don't have to go all around the barn trying to guess, anticipate and surmise and to conjecture. We would have it all laid out before us. Isn't that what all these statements are intended to achieve? Let's get it directly instead of trying to peek and imagine as to what might be behind the bikinis as I put it.

Answer:
We both know what management's reaction would be to requests for all that information. If you think of what management does on a day-to-day basis and how management probably looks at two numbers every day, the sales from the prior day and their cash position. And they get that on a daily basis and they probably have some of the most sophisticated cash management systems going and they monitor cash all along. Gee, if it is that important for the company, why shouldn't some of this, in some fashion, be presented to the shareholders. I'm not just talking about delivering everybody a bushelbasket full of information, but if there would be some way to put out a reasonable amount of data in the forecast, at least some sort of management forecast, I think it would be a good thing. I don't support just supplying tons of information. I wouldn't know what to do with half the stuff and I wonder how many people do. Sometimes you think people want information just to get one more little bitty piece of what is going on. The SEC at one point was encouraging forecasts. It sounded like they were going to have some very strong requirements for forecasting. Then they stepped back and left it optional. I think you were supposed to report if there was a change in your forecast. I really don't know where the safe harbor rules stand on forecasting today, but the SEC made an attempt at it. The Board seems to be saying that forecasting would be nice but they are not ready to lock in on that. They are having enough trouble reporting on what is happening, being historians.