

5 March 2007

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Dear David

ED 151 *Australian Additions to, and Deletions from, IFRSs*

The Financial Reporting Standards Board (FRSB) of the New Zealand Institute of Chartered Accountants is pleased to comment on the Australian Accounting Standards Board's (AASB) exposure draft ED 151 *Australian Additions to, and Deletions from, IFRSs* (ED 151).

General Comment

The FRSB welcomes the proposals in ED 151. The FRSB notes that many of the proposals to revert to IASB wording will result in increased convergence between New Zealand Equivalents to IFRSs (NZ IFRSs) and AIFRSs.

ED 151 sub 15

Our review of the effect of the proposals in ED 151, twelve AIFRSs and NZ IFRSs were converged. As a consequence of the proposals in ED 151, another five Standards will be converged. Of the remaining Standards that are not converged, the proposed amendments in ED 151 will decrease many of the individual divergences that currently exist between the two sets of Standards. We consider this to be a positive outcome.

IAS 7 Cash Flow Statements

Of the proposals in ED 151, we note that one proposal will create a divergence between AIFRSs and NZ IFRSs. This relates to the proposal to reinstate the option of presenting cash flows from operating activities using the indirect method and to delete the requirement for a reconciliation of cash flows arising from operating activities to profit and loss¹.

At present, both AASB 107 and NZ IAS 7 do not contain the option to use the indirect method and both Standards require a reconciliation of cash flows arising from operating activities to profit and loss. ED 151 proposes to reinstate the option to use the indirect method and remove the requirement for the reconciliation. This proposal will increase the divergence between the two Standards.

In relation to this proposal, we draw your attention to research² in this area that indicates that:

- The direct method provides information that is not available from the balance sheet and profit and loss statement;
- The direct method best reflects the gross inflows and outflows of cash from operating activities; and
- The direct cash flow components and reconciliation items have higher predictive ability than information from the indirect method and have additional ability to explain share price returns (over and above operating cash flows).

¹ Note, however, that the proposal in ED 151 to reinstate paragraphs 34 [classification of dividends] and 50(b) [disclosure of cash flows relating to joint venture entities using proportionate consolidation] of IAS 7 in AASB 107 will increase convergence between AASB 107 and NZ IAS 7.

² We attach, for your information, a paper prepared by FRSB member, Professor Michael Bradbury, for the FRSB summarising the relevant research in this area.

At the time of adopting IAS 7 as NZ IAS 7, similar considerations were taken into account in the FRSB's decision to eliminate the indirect method. A further reason cited was that it was consistent with the approach in Australia when IAS 7 was adopted in Australia.

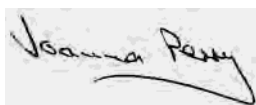
We note that the IASB, at its meeting in December 2006³, "*expressed a leaning towards requiring (i) all categories in the statement of cash flows to be presented using the direct method and (ii) the information needed to reconcile operating income and cash flows from operating activities to be presented in the financial statements.*" The IASB also asked the staff to consider whether similar reconciling information should be provided for the financing and investing categories.

Given that the reasons for mandating the direct approach remain valid and the IASB's current "leaning" with regard to IAS 7, New Zealand does not intend to make any changes to NZ IAS 7 at this time.

We look forward to working with the AASB on eliminating remaining differences between our Standards.

If you have any queries or require clarification of any matters in this submission, please contact Joanna Yeoh (Joanna.yeoh@nzica.com) in the first instance, or me (joannaperry@xtra.co.nz).

Yours sincerely

A handwritten signature in black ink that reads "Joanna Perry". The signature is written in a cursive style with a long, sweeping underline.

Joanna Perry
Chairman – Financial Reporting Standards Board

³ IASB Update December 2006.

Evidence on Reporting Direct and Indirect Cash Flows

Introduction

At the February 2007 FRSB meeting I was asked to summarise the evidence on the usefulness of reporting of direct versus indirect cash flow statements. I summarize this research below and provide a review selected studies in Appendix A.

Terminology

Any discussion on direct versus indirect cash flows can result in confusion because of different use of these terms. I, therefore, identify the terminology used in this document. I refer to “direct” and “indirect” as methods of *presentation* of cash flow statements. The direct method provides gross inflow and outflow components of cash flow from operations.

I do *not* refer to “direct” and “indirect” to mean the method of *preparation*. A cash flow statement may be prepared “direct” from the cash book or coded from bank statements. The cash book method of preparation is more difficult for consolidated cash flow statements (although XBRL might facilitate direct preparation). The “indirect” method of preparation refers to the method of reversing the effect of accruals from the income statement using information on the change in balance sheet items.

Support for the direct method

Both the IASB and the FASB consider the direct method as the preferred method of presenting cash flow from operations:

In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum – the net cash flow from operating activities (the direct method). (FAS 19, para 27).

Entities are encouraged to report cash flows from operating activities using the direct method. (IAS 7, para 19).

Some argue that the indirect method is simpler for users to analyse (Rosen and DeCoster 1969). On the other hand, O’Leary (1988) claims that the direct cash flow presentation better represents an entity’s cash cycle and is more user-friendly for managers not possessing substantial accounting knowledge. The Association for Investment Management Research (AIMR) supports the direct method:

We note that Robert Morris Associates, representing more than 15,000 bank loan and credit officers in the United States, has adamantly advocated the direct method. AIMR (1993).

One of the purported advantages of the direct method of cash flow statement presentation is that it provides additional information. The “...direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method” (IAS 7.19).

Arguments against the direct method

Some do not agree that the direct cash flow statement provides additional information. The particular arguments are:

- That the additional information provided by the direct method is not useful.
- That the additional information provided by the direct method can be easily estimated by analysts.
- The additional information provided by the direct method is costly to prepare (relative to the benefits).

Empirical Evidence

In this section I summarise the evidence in relation to each of the arguments against reporting of the direct cash flow statements.

Is the direct cash flow statement useful?

In an experimental setting, Klammer and Reed (1990) find that in making a loan decision, analysts with indirect format cash flow statement produce different decisions than did those presented with the direct statement. The direct method of presenting cash flows from operations reduces task errors, enhances understanding of the information, and results in a lower variation of the resulting decision.

For a sample of 405 US firms, Krishnan and Largay (2000) find that direct method information provides a better predictor of future operating cash flows than indirect method information. They also find that information on the gross amounts of cash receipts and cash payments (i.e. the direct method components) is more relevant than information on the net amount.

For a sample of 146 Australian firms (648 firm-year observations) over the period 1997 to 1992, Clinch et al. (2002) use share price returns to investigate three primary questions relating to the usefulness of direct and indirect cash flow disclosures. First they find that direct cash flow components and reconciliation items have additional ability explain share price returns (over and above operating cash flows). Second, this relation is stronger when direct cash flow components and reconciliation items have additional ability to predict future operating cash flows. Third, *reported* direct cash flow components have incremental explanatory power of returns compared to *estimates* of these components (using accrual reversal methods).

Gahlon and Vigeland (1988) estimate direct cash flows (Pre-FAS 95 data) and related variables and find them to be significant in discriminating between bankrupt and non-bankrupt industrial firms as much as five years before bankruptcy. Trout et al. (1993) describe how the Chicago Central Pacific Railroad used a direct method cash flow report as a key managerial tool while re-organising under Chapter 11. Smith and Freeman (1996) survey municipal finance directors and find they prefer the direct method on five different criteria. However, the subjects favour augmenting the direct format with the supplementary indirect reconciliations.¹

¹ The evidence from Gahlon and Vigeland (1988), Trout et al. (1993) and Smith and Freeman (1996) was reported and extracted from Krishnan and Largay (2000).

Ding et al. (2006) sample 1000 Chinese companies over (1998-2004) and find the indirect method has significantly greater ability to predict future operating cash flows than the direct method, when the business of the firm is volatile. When the business is stable, there is no predominant method. They conclude "...that by requiring disclosure of both decompositions, accounting regulators help investors to better assess the future performance of the firm."²

Can the additional information provided by the direct cash flow statement be estimated by analysts?

In an efficient market (where information is publicly available) it should not matter where information is disclosed. If analysts can estimate direct cash flow information from the income statement, balance sheet, the indirect cash flow statement, and notes then there is a strong case for arguing there is no benefit for making the direct cash flow statement mandatory. However, this argument would also imply that there is no need to report the cash flow statement in the first instance! The AIMR argue:

In many cases, the level of detail presented in an enterprise's income statement is inconsistent with that in the cash flow statement, and it is consequently impossible to make all the necessary adjustments. (AIMR 1993).

Austin and Bradbury (1995) show that mechanical procedures for estimating cash flow data provide poor estimates of reported cash flow numbers (i.e., cash flow from operations and direct cash flow components). For, example, the error in cash from customers (payments to suppliers) is, on average 5% (6%) but ranges from 0% to 71% (0% to 75%). They find that even using footnote data, large errors still remain. Furthermore, the errors are correlated with firm specific attributes (e.g., firm size, losses) which means that errors are larger in contextual situations (such growth, acquisitions and the assessment of failure).

For a sample of 405 US observations, Krishnan and Largay (2000) find that the measurement error for cash collected from customers is less than 1%. For cash paid to suppliers and employees it is 4.4%.

Is the direct method too costly to prepare?

Golub and Huffman (1984) argue that the indirect method is easier for preparers to create. However, there is not much evidence on the cost of preparing the direct cash flow statement relative to the indirect method. There are two points worth considering:

- First, the "too costly" argument is inconsistent with the argument that analysts can easily make the adjustment. If it can be done by the analyst, it could be more easily done by the reporting entity and it need only be done once. Thus saving the costs of thousands of analysts.
- Second, firms in New Zealand already present cash flow statements using the direct method.³ The marginal cost of retaining direct cash flow statements is low on the preparer but potentially high on the user if the indirect method is reported.

² I was not able to access this paper, only an abstract.

³ Although, most firms in NZ (e.g., unlisted companies) take the DIFFREP exemption and do not prepare cash flow statements.

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APPENDIX A: RESEARCH ABSTRACTS

Austin and Bradbury (1995)

From a random sample of 25 New Zealand companies in 1990, Austin and Bradbury compare three methods of estimating cash flows (commonly used in the research literature) with reported cash flows. They also examine the accuracy of estimating operating cash flow components that are reported in the direct cash flow statement. The results show that operating cash flow reflects a different attribute of the firm than net income. There are large errors in constructed cash flow numbers (median errors of around 10% of the reported operating cash flow). The error in cash from customers (payments to suppliers) is, on average 5% (6%) but ranges from 0% to 71% (0% to 75%). They find that even using footnote data, large errors still remain. These errors are correlated with firm specific attributes (e.g., earnings, inventory, foreign currency and size) which suggests that errors are likely to be related to firm events (e.g., acquisitions, asset sales, growth).⁴

Krishnan and Largay (2000)

Krishnan and Largay find 405 firm-year observations reporting cash flows under the direct method in the US, over the period 1988-1993. Using three years data (1988 to 1990) they undertake cross-sectional regressions to develop one-year ahead operating cash flow predictions for a three-year hold out period (1991 to 1993). One model uses the direct method data and the other uses the indirect method data. They then compare the accuracy of these models. The results, based on yearly and pooled models, indicate that direct method information has higher predictive ability than indirect method information. They also find that information on the gross amounts of cash receipts and cash payments (provided by the direct method) are more relevant than information on the net amount.

Clinch, Sidhu and Sin (2002)

For a sample of 146 Australian firms (648 firm-year observations) over the period 1997 to 1992, Clinch et al. (2002) assess the ability of cash flow data to explain share price returns to investigate three primary questions relating to the usefulness of direct and indirect cash flow disclosures.

- First, they find that direct cash flow components (cash from customers, cash to suppliers) and accruals (items taken from the reconciliation) have incremental ability (compared to (net) operating cash flows) to explain returns.
- Second, where direct cash flow components and reconciliation accrual items have incremental ability to predict future operating cash flows, they have further ability in explaining returns.
- Third, *reported* direct cash flow components have incremental ability to explain returns compared to *estimated* components (calculated using accrual reversal methods).

Klammer and Reed (1990)

Klammer and Reed carried out an experiment with 151 bank analysts and loan officers, who were asked to study a set of financial statements, answer a series of questions about the entity and make a decision whether to grant the company's loan request. The analysts had identical financial data, except that one group had a direct cash flow statement and the other had an indirect statement. The two groups produced different decisions. The direct method of presenting cash flow from operations reduced task errors and enhanced the readers' ability to understand and apply information. This resulted in a lower variation of the resulting decision for this group.

⁴ Similar evidence on operating cash flows is provided by Hribar and Collins(2002) Bahnson et al. (1996) and Guay and Sidhu (2001). However, these studies do not examine direct cash flow components.