

University of Veszprém

József Veit

**THEORETICAL AND PRACTICAL PROBLEMS OF
PREPARING CASH FLOW STATEMENTS BASED ON
ACCOUNTING DATA**

Theses of a PhD dissertation

**Veszprém
2005**

**University of Veszprém
Doctoral School of Economic and Management Sciences**

József Veit

**THEORETICAL AND PRACTICAL PROBLEMS OF
PREPARING CASH FLOW STATEMENTS BASED ON
ACCOUNTING DATA**

Theses of a PhD dissertation

**Consultant:
Dr. Erzsébet Dimény**

**Veszprém
2005**

TABLE OF CONTENTS

I. Goal and antecedents of the research	4
Research goal	4
Antecedents of the research.....	6
II. Research methodology and the structure of the dissertation.....	6
Structure of the dissertation.....	7
III. The theses of the dissertation; research findings.....	7
The theses of the dissertation	7
IV. Utilisation of the research findings.....	13
V. Publications and applications related to the topic of the dissertation	15

I. Goal and antecedents of the research

Research goal

Numerous publications are available for professionals concerned as well as the interested public on the presentation, contents and breakdown of cash flow statements based on accounting data. Most of them address general issues from a global standpoint. This is a logical consequence of the system of financial reporting. However, when faced with the annual task of preparing a cash flow statement, practising accountants, and auditors have to tackle problems which are formulated as questions of detail. In methodological terms, it is of course always easier to take a stand on matters of detail than to find the appropriate and full-fledged solution to global problems¹. In the course of my research I sought answers to several of these problems of detail exploring at the same time the deficiencies of the Hungarian regulatory system regarding the cash flow statement and comparing it to international regimes, taking into consideration the regulatory mechanisms of countries which have a dominating influence in the field. (USA – FAS 95, United Kingdom – FRS 1)

The principal aim of cash flow statements is to provide information about cash inflows and outflows of an undertaking during a given period. To use a comparison, the cash flow statement is like telling how much coal a mining company excavated from 1 January to 31 December. This amount is naturally not there at a given moment of time – as indeed the cash is not there either. It also serves as a performance indicator, which should be independent from the profile of the business. Thus it is immaterial whether it is a production company or a financial institution, cash is required for all undertakings. Cash flow statements report on transactions related to the changes in cash. Thus items which do not involve cash movements are excluded. This exclusion, however, raises important economic questions as to the contents reported. To quote a few simple examples, in the case of a loan secured for the acquisition of fixed assets, if the bank makes payment directly to the seller, it is not considered as investing cash outflow but as financing from the first repayment². When defining cash equivalents, investments with original maturities shorter than three months are seen differently from investments whose remaining maturity is less than three months but which have been originally purchased for a longer period³. Obviously, economically speaking, there should be no difference in the assessment of these cases. So economic problems are excluded from the analysis.⁴

¹ In mathematical statistics factor analysis and cluster analysis also start from questions of detail when trying to find solutions for the whole through hypothetical variables.

² Cf. FAS 95, Statement 17.c, footnote 6.

³ Cf. FAS 95, Statement 8.b, footnote 2.

⁴ All the more so as *value* in the accounting sense not identical with *value* in the economic sense.

In Hungary the statement is purely cash-based¹. Historically, cash flow statements have come a long way until they reached their current form. Even the basis of their makeup can differ substantially. According to the U.S. practice and the IAS 7 the statement is prepared on a similar basis, which includes cash equivalents in addition to cash. But as it is left to undertakings to define cash equivalents, the end result may strongly vary. The FRS 1 cash basis is more restricted than the previously mentioned regimes as it does not include cash equivalents.

In the statement cash flows from operating, investing and financing activities are separated. The lack of uniform classification of transactions exacerbates the difficulties of comparability. There is no agreement on major issues such as interest received and paid, dividends received and paid, and profit tax. There seems to be total chaos in these areas. According to the IAS 7 they can be classified anywhere if their contents so justifies. In the reporting practice of the U.S., they are arguably classified under operating, investing, or financing activities, as the case may be. The Hungarian practice is similar: interests and dividends paid fall under operating cash flow, while dividends received are considered as investing cash flow.

What method should be used for preparing the operating cash flow? Should the indirect or the direct method be applied? Should extraordinary items be classified separately or not? The FRS 1 tries to solve the classification problem by setting up five more classes in addition to the three main areas of the cash flow statement. They include taxation (profit taxes) and dividends paid. Interestingly enough, the FRS 1 prefers the indirect method as opposed to the IAS 7 and the FAS 95. The Hungarian regulatory system relies on the indirect logic for cash flows from operating activities but embraces the direct method for cash flows from investing and financing activities. This mixed system alone gives rise to most of the statement problems in practice. The IAS 7 is rather “lenient” in this respect, too². For operations, both the direct and the indirect method is applicable as well as alternative procedures. Extraordinary items³ do not have to be classified separately in the cash flow statement but information must be provided about them.

As regards the cash flow statement, the Hungarian regulations are rather rudimentary, hence without traditions. The deficient regulatory mechanism does not provide footholds for accountants. Unfortunately other countries’ practices or indeed the IAS 7 do not always provide guidance to fill the gaps in our system. The last revision of the standards referred to above took place rather a long time ago: the FAS 95 entered into effect in 1987, the IAS 7 in 1994, and the FRS 1 in 1996, and their amendment has been overdue. In Hungary, cash flow statements were first prescribed in

¹ It does not even include bank overdrafts, which is a significant difference compared to other mechanisms.

² The IAS 7 was conceived at a time when IASB followed this strategy: its only tool to promote the introduction of the IAS was moral conviction. Today this strategy no longer prevails; rather an individual detailed and all-encompassing regulatory system is followed. Cf. the length of the IAS 39 and its Conclusions.

³ Although the IAS 7 has never actually been amended, as of 31 March 2004 it has been brought in line with the amended standards and Articles 29 and 30 were deleted.

1997, without any specific regulatory explanation. Partial legislation was enacted in 2000 with no substantial change since.

The research

- is focused on the Hungarian accounting practice;
- highlights the difficulties, problems, contradictions and shortcomings of the cash flow statement, which is one of the statements required by law in the Hungarian financial reporting system; and
- concentrates on solving practical problems relying on the theoretical guidance provided by predominant regulatory mechanism.

Antecedents of the research

When developing the Hungarian Accounting Act, the presentation of cash flow statements also arose besides a number of other issues. For undertakings required to submit an annual financial report it has been mandatory to prepare a cash flow statement since 1997. In the Hungarian financial reporting practice there had been attempts to introduce annexes similar to the cash flow statement even before the political changeover, for instance the table titles Liabilities and Their Allocation used in the 1980's was such an attempt. However, the expertise and experience of accountants was not enough for their implementation at sufficiently high standards, i.e. for providing a true and fair view. Precious little is available in the Hungarian which would help practitioners achieve more adequate solutions. As a lecturer I have often encountered these deficiencies, which induced me to spend much time and effort on studying the theory and practice of issues related to the cash flow statement over the past eight years.

II. Research methodology and the structure of the dissertation

In the course of the research I prepared educational materials, teaching aids and textbooks dealing with questions and problems of detail mainly for auditors, financial managers, auditor candidates and university students. I never addressed all of the problems, nor did I seek ways to include them in a system. After raising the practical problem I clarified the possible theoretical approaches and then identified the specific acceptable practical solution primarily in consideration of the relevant legal regulations. To find the solutions it was often necessary to delve into other regulatory systems, namely of the United States and the United Kingdom, and into the International Accounting Standards. Against the background of this knowledge I hoped to better explore and solve some of the problems rooted in the Hungarian regulatory system.

Structure of the dissertation

In Chapter One of the dissertation the possible forms of analyzing the financial position are discussed with special regard to cash flow statements. Chapter Two addresses general questions of cash flow statement and describes the basic terms, concepts and relations. In Chapter Three the dominant regulatory mechanisms are reviewed based primarily on the structure of the IAS 7. Reference is made to some of the characteristic features of the Hungarian system. Chapter Four addresses specific questions of regulation under the Accounting Act¹ and related problems and their solution. The practical solution of theoretical problems will be proved by accounting demonstration which relies on the minimum cash flow structure required under the Accounting Act. These formal solutions are intended to help readers to find their way in the complexity of problems that cause serious difficulties in everyday practice. The chapter also addresses non-designated adjustment items, which are currently missing from the accounting regulations but deserve as much attention as designated issues. At the end of the chapter an attempt was made to systematize the problems (which denote, in fact, different types of transactions).

III. The theses of the dissertation; research findings

The theses of the dissertation

Thesis 1:

The cash flow statement as a major part of the financial statement is of special significance in the current and future assessment of the financial position of undertakings.

Because of their dynamic nature cash flow statements are more suitable for the analysis of the historical financial position of companies than static liquidity balances. Investors and creditors need orientation with regard to the following issues:

1. Will the undertaking be able to produce a positive cash flow?
2. Will it be able to redeem its liabilities and to pay dividends?
3. What causes the difference between income and cash inflows and between expenses and outflows?
4. Cash and non-cash aspects of investing and financing activities of undertakings should also be presented.

¹ Hungarian Act C of 2000 on Accounting (hereinafter: Accounting Act)

Its characteristics:

- It is generally a major part of the financial statement besides the balance sheet and the profit and loss statement. In Hungary it is a part of the notes.
- It is suitable for measuring the present fulfilment of past forecasts.
- It is suitable for estimating future cash flows.
- It can provide data for financial indicators.
- The difference between the income from operation and the net cash flow from operating activities reflects the “quality” of income.

Furthermore, it can be used for the following:

1. Determination of the company's ability to generate value.
2. Liquidity planning.
3. Follow-up analysis.
4. Exploration of possible additional sources for the growth and expansion of the business.

Thesis 2:**The cash flow statement is more than a mere liquidity analysis.**

The static liquidity analysis compares the liquidity of assets with the maturity of liabilities. It examines the process of conversion of assets into cash. The conclusions drawn from liquidity analysis are often subjective and highly short term and as such they do little to support analysis. The analysis of liquid assets is not based on the data in the financial report, therefore it is not treated in the dissertation. By contrast, the actual in and outflows of cash are based on concrete facts, thus they are eminently suitable for forecasts as well as analysis. Cash flows reflect the function of money as a measure for value, something other financial statements are unable to convey in a similar fashion. (Valuation in accounting is somewhat different and is debated in financial economics as it is unable to handle the time and risk factors. Taking the rules of fair valuation into consideration, this is no longer entirely true.)

Besides analysing the liquidity position the cash flow statement has another important function: it captures profit in a way different from accounting valuation. The relationship between profit as it appears in accounting and cash flow highlights this difference, this is why a cash flow statement can be a more valuable or advantageous component of the financial report than a profit and loss statement. However, there is no argument among accountants as to the primacy of the profit and loss statement and in the current Hungarian practice the tracking of cash flows is not the most important issue as long as businesses have no liquidity problems.

Thesis 3:

On the surface the major influential international cash flow statement regimes show significant convergence while they continue to be vastly different in terms of detail.

Convergence on the surface naturally has an effect on contents. The structure and contents of statements has been regulated at different levels. The past years have been dominated by the Anglo-Saxon practice. It was in the Anglo-Saxon world that the first reporting standards were devised, the FAS 95 U.S., the FRS 1 U.K. and the IAS 7 International Accounting Standards. Their structure relies on the common concept of distinguishing the areas of operation, investment and financing. They also have the common feature of considering these areas to be one of the main parts of the financial report. But when it comes to classification, they embrace differing concepts, which the IAS 7 tried to resolve, at its conception, by supporting all practices adopted so far at the level of implementation. This includes the classification of taxation and dividends in the cash flow. The cash-basis of the cash flow statement also differs. Some systems only include cash, others add bank overdrafts, yet others rely on cash equivalents, or include cash flow information based on working capital movements. The Hungarian regulatory system is no exception. Debated issues have remained debated in this country, too, at times for technical reasons rather than for reasons of contents.

Such questions include the following:

- In cash flows from operating activities the Accounting Act provides for the application of the indirect method, while in the areas of investing and financing the direct method should be applied.
- The handling of taxes and dividends paid and payable.
- Classification of loans granted.
- The Hungarian regulations rely on a purely cash basis.

Thesis 4:

The current regulation of cash flow statement relies on “liberalism” and the “judgment of experts”.

As opposed to codified legislation (i.e. regulation through specific statutory provisions), which is the norm in continental Europe the Anglo-Saxon regimes do not try to be all-inclusive, instead, they set forth the prohibitive measures in their legislation. Everything is permitted unless it is expressly forbidden by law. In Hungary, Professor Tamás Sárközy labelled this “negative legitimacy”: whatever is not prohibited by law is permitted. However, legal implementation has

not followed this practice over the past decades. The masses of itemised regulations issued over the years left little room for independent spirit in financial reporting. Individual solutions were avoided as they destroyed comparability. But this led to elimination of information from the financial reports which unveil features characteristic of the undertaking. At the opposite end, the Anglo-Saxon model left ample room for individual features presented in an individual fashion. It is difficult to decide which is the best solution. Some are of the opinion that the Anglo-Saxon approach just thickens the smoke-screen rather than providing discernment by letting individual opinions in the system. Unfortunately, undertakings are not inclined to change their ways of their own accord and disclose everything in their reports in compliance with the philosophy of providing a true, fair realistic, and accurate etc. view of their business. This is why the institution of auditing was introduced. But rules should not necessarily be made while relying solely on the professionalism of the management and auditors – as shown by the accounting and auditing scandals of recent years in Hungary and abroad.

Thesis 5:

Classification in the statement is often arbitrary and depend more on the accounting rules in a country than on the actual contents of transactions.

Several examples are provided in the dissertation to illustrate this problem. Countries have taken differing positions on several very important issues such as taxation, the presentation of dividends and the classification of interest. As regards taxation, the possibility of their allocation to activities has been raised, and this logic has been embraced by the IAS 7. The same applies to interest received and paid, which can be classified virtually anywhere under the IAS 7. The Hungarian regime also contains peculiar solutions, for example the presentation of own shares transactions, where the changes of capital netted of yields and expenses can be included in the cash flows of financing activities. Although this solution seems to be contrary to the IAS 7 approach, the contradiction is only apparent, because the lenient nature of the IAS 7 may result in several correct solutions. Classification of long terms loans granted under the heading of financing is also a special problem. In the determining regulatory systems this item is generally classified as investment. In the Hungarian system the names of the line items are indicative of their contents. The name “loans granted” does not express the fact that this line item should also include long terms receivables and fixed period deposits. Short term loans granted are not mentioned in the Hungarian system, which means that its accounting classification should probably be considered as governing.

Thesis 6:

Cash flow statements only include the effect of transactions involving cash movements. All transactions which do not involve cash movements should be excluded from the statement.

The main reason for this is the data included in the other two main components of the financial statement, the balance sheet and the profit and loss statement. These two main parts of the financial report contain all changes in assets and profits but are unable to provide information on the impacts that occurred in cash. Thus the difference between profit and loss and cash flows provided a valuable insight for the user of the statements. The bigger the difference between the profit and the operating cash flow values the greater the likelihood of the business running into financial difficulties, or that the cash flows will take place outside the financial reporting period. An outstanding example mentioned in the dissertation is acquisition of fixed assets financed from credit, where no disbursement is made, therefore the transaction cannot be included in the statement. Moreover, economics considers this transaction entirely differently, as investment has actually occurred but there has been no change in the investing cash flow; instead, only financing is stated, from the first repayment. Conversely, if the credit is disbursed that means actual cash flows and everything falls into place. This is when we start wondering what the cash flow statement actually shows, what we want to measure with it. If we modify the previous case whereby the acquisition was temporarily financed by the investment supplier (seller), to whom we had previously paid an advance, the previous year, the reporting year as well as the following year may be interesting in terms of the cash flow statement as the transactions must be followed through not only in the accounts but also in the cash flow statement. The question is, how far should tracking go in practice. Specific cases suggest that it is only the preceding year, the year of reporting and the following year that are interesting. See also cases for acquisition from credit, lease transactions, instalment purchase schemes, etc.

Thesis 7:

The deficiencies of the Hungarian regulatory mechanism can be partially supplemented by provisions from the international and determining regulatory systems.

It is generally accepted that the Hungarian regulatory system has deficiencies. Looking at some of the line items, it is impossible to decide whether they serve for **technical or contents** purposes. Consider the line item Taxes paid or payable (on profit). What does it stand for? The after-tax profit on the accounts should be reconciled with the statement, therefore earnings before taxes should be netted of taxes and dividends payable. But in this way the issue becomes purely technical, and the line item will not reflect the actual cash movements. Operating cash flows are

suitable for exploring many similar problems, which need to be bridged in order to find the correct solutions. As regards non-regulated issues, the majority of the systems discussed in the dissertation are eminently applicable, particularly in consideration to the strengthening role of the IAS 7. For example significant impacts on the structure of assets and capital which, however, do not involve cash flows can be demonstrated in the notes outside the cash flow statement. Such an impact is assets received as in-kind contribution, assets received without consideration, or trust assets.

The scope suggested by the name of the line item only triggers a sense of loss in the accountant. Consider the meaning of the line item “1. Earnings before taxation”. One possibility is that it coincides with the line item of the same name in the profit and loss statement. This, however, is hardly likely, as the regulations provide for adjustment of this line item in the profit and loss statement to operating cash flows in different situations. Another possibility is that the item denotes income from operation (profit before taxation netted of income and expenditure which did not involve cash movements). Unfortunately, this is not true either, as line item 5 is a special adjustment, and as such, it is contrary to this concept. Perhaps this deficiency is rooted in the incomplete and somewhat patchy system created by the legislator, a system which provides little foothold for those implementing it.

Thesis 8:**The content of cash flow statements should not depend on the rules peculiar to accounting.**

The separation of natural and cash movements in terms of time gave rise to the need for the data reflected in the cash flow statement. We often book transactions which have an effect on income, assets and capital structure but do not involve cash movements. Countless examples can be mentioned. In addition to these items, there are complicated transactions which involve cash movements but due to the complexity of their accounting reconciliation is difficult, i.e. it is difficult to decide to which acquisition the outflow of cash should be assigned. A classic example to illustrate this problem is an acquisition where no subsidiary is created but only assets and liabilities are taken over (cf. Acquisition as defined in the IFRS 3.). A possible resolution for this contradiction could be to dispense with accounting for the interim transactions, and natural and cash movements with only a minimum difference in time would be matched without being entered on the books. Examples can be quoted to illustrate the supremacy of accounting. For instance, repurchased own shares resold by the undertaking. As such shares are considered as securities purchased for trading in accounting, their cash flow impacts fall within the scope of operations, whereas in terms of content, they fall under financing cash flows in all systems. To find the right solution cash flow classification should entirely disregard accounting classification. The same applies to advance paid on fixed assets. But there are also good examples for independence: short

term loans received, which is related to operation but appears under the heading of financing, in my opinion, correctly. This is how attention is drawn to leverage, and this is how we have an answer to what would have happened without the involvement of external funds. (No wonder the profit and loss statement removes the effect of financial transactions from operation.)

IV. Utilisation of the research findings

The findings of the research can contribute to:

- further development of the Hungarian accounting rules;
- a fundamental change in the approach to the cash flow statement;
- development, expansion and supplementation of teaching materials for secondary and higher education;
- preparation of a “manual” for practitioners of reporting.

It is justified to amend and fine-tune the Hungarian regulatory system in the near future. A prime opportunity is the development of the Hungarian accounting standards. The organisation has already been prepared, and the commencement of actual work is imminent. When drafting the standards the role of cash flow statements in accounting should be unequivocally clarified.

The current Hungarian practice raises problems of approach in addition to those of methodology. My experience as an auditor and a lecturer has shown over the years that auditors do not pay sufficient attention to auditing cash flow statements. This is probably due mainly to a lack of expertise. A lack of history also leaves its marks on the quality of solutions. Conversely, if despite these deficiencies the auditor adopts a positive attitude s/he is likely to be unable to think in systemic terms. Nevertheless, it is easy to recognise the simple fact that cash flow statements should only contain transactions which generate cash movements and all superfluous impacts should be excluded as distorting. This nice sounding statement, however, is often complicated by the accounting of rather complex transactions. Application of the indirect method calls for demonstration techniques which are by no means so obvious. Take the example of purchasing some tangible asset, where we only paid the supplier a part of our debts, and that, from development support funds. As there are a lot of similar lines of thinking to be analysed in the course of demonstration, the task is not at all easy.

It is also necessary to enhance education in this area, which calls for new educational materials supported and illustrated by examples. Currently used textbooks seem to have been stuck at the level of generalities, which results in the inability of users to solve problems they encounter with in

practice. Twenty years of experience as a lecturer in higher education and over 12 years of experience in auditor training support these statements.

In order for professionals to be able to prepare a cash flow statement of appropriate quality standards they need guidance and support, which help or reinforce the solutions driven by their expertise. This is what the Accounting Act attempted by raising, interpreting and providing for certain problems as a precedent. Masses of textbooks of different quality and contents have been published in a variety of areas in accounting motivated by the same needs.

V. Publications and applications related to the topic of the dissertation**Own publications related to the topic of the dissertation:**

1. Adorján-Bary-Lukács-Róth-Veit: A számvitel és mérlegelemzés alapjai (Basic accounting and balance sheet analysis). Bankárképző dobozok Vol. III. Nemzetközi Bankárképző Központ, 2000.
2. Adorján-Bary-Bíró-Fridrich-Garajszki-Kresalek-Lukács-Nagy-Pál-Róth-Ujvári-Veit: A számviteli törvény magyarázata (Explanation to the Accounting Act). Hvgorac 2004-2005. Vol. II, Explanation to Annex 7, Part c, p. 1098.
3. Róth-Adorján-Lukács-Veit: Számviteli vizsgafeladatok (Examination problems for accounting students). MKVK OK (Published by the Hungarian Chamber of Auditors), Budapest, 2003.
4. Veit, József: Einige theoretische und praktische Probleme der Erstellung von Cashflow-Rechnungen (Theoretical and practical problems of the cash flow statement). Europäische Akademie, Wien, 2005.
5. Adorján-Borzáné-Dömötörfyné-Gubányiné-Lukács-Nagy, K.-Papp, J.-Róth-Szabó, M.-Veit: Számvitel és elemzés II. kötet (Accounting and analysis, Volume II). MKVK (Hungarian Chamber of Auditors) 2003.
6. Adorján-Bary-Lukács-Róth-Veit: A számvitel és mérlegelemzés alapjai (Basic accounting and balance sheet analysis). College textbook. 3. Elemzés a számvitelben (Analysis in accounting). Budapest, 2000. Textbook of Gábor Dénes College.

Own applications related to the topic of the dissertation:

1. Lecturing the course Accounting and Analysis at Corvinus University of Budapest.
2. Lecturing courses for auditors and auditor candidates in the context of the programmes of the Hungarian Chamber of Auditors.
3. A cash flow-kimutatás könyvvizsgálata (Cash flow statement auditing). Presentation delivered at the National Auditors' Conference. Balatonszáplak, 2001.
4. A számviteli törvény szerinti cash flow-kimutatás összeállításának néhány elméleti és gyakorlati problémája (Theoretical and practical problems of the cash flow statement under the Hungarian Accounting Act). Presentation delivered at the Accounting Conference staged by the Budapest University of Economics. Budapest, 2002.