Doctoral School in
Business Administration

SUMMARY OF THESES

László Norbert

To the Ph.D. thesis entitled

Statement of Cash flows in the Financial Statement

Supervisors:

Bosnyák János, Ph.D
associate professor

Pavlik Lívia, Ph.D
associate professor

Budapest, 2013

Department of Manegement Accounting

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1. Aim and antecedents of the research

Efforts to regulate cash flow statements in reports date back to relatively recent times, as even Anglo-Saxon countries, in the forefront of this field, only imposed the obligatory use of these statements some twenty years ago. Yet this short period of time has been sufficient for this statement to expand all over the world and appear as a mandatory element of the report in an ever increasing number of countries worldwide. This mainly applies to larger companies; smaller firms tend to be exempted from the presentation of a cash flow statement for the sake of simplification. Cash flow statement regulations are broadly similar in the various countries—international research has indeed shown that this is the accounting standard with the least differences in the application; yet having a closer look at the details, we are bound to find many minor differences rooted in the particular features of each country.

In my dissertation, I study cash flow statements presented in the accounting statements of profit-oriented companies. Another restriction is that the companies concerned shall not operate in a special industry (such as credit institutions, insurance companies, national administrative bodies), for these organisations function in a somewhat different way in respect of their cash flows. I especially examine those versions of cash flow statements which appear in public general-purpose accounting statements, and limit my subject matter to ignore statements of cash flows serving specialised (i.e. internal accounting or financial) purposes. I broke my research subject down to three subtopics for analysis: 1) stakeholders' information needs; 2) regulatory frameworks and actual practices; 3) the informative value of cash flow data. Each of these necessitates the description of the theoretical background, the current practice and the previous related studies. The dissertation has primarily been structured according to this latter classification, and the three examined subtopics are presented within this threefold structure. I will present the resulting structure below.

In the first part, I will give an overview of the theoretical fundamentals of the subject matter through the presentation of the pertaining academic literature. In doing so, I will touch upon the concept of 'value' as used in economics and in accounting; this is necessary for the deduction of the concepts of 'income' and 'cash flow' to be used for the purpose of performance measurement. Subsequently, I will discuss the evolution of accounting theories, which will lead us to the issue of provision of information based on the needs of the stakeholders of financial reporting. Illustrated on the business cycle of the firm, I will present the problems concerning the timing and comparison of performance measurement; compare accrual-based and cash-based accounting; and compare the income statement based on the realisation principle with cash flow statement. To conclude, I will discuss the theories behind cash flow statements, introducing them in a general way in a hypothetical unregulated environment.

The second part discusses the practical implementation of the theory outlined before, i.e. the regulatory frameworks the individual countries and international accounting systems (IAS/IFRSs) have established for cash flow statements. This field has had the longest traditions (if no more than a few decades) in the Anglo-Saxon countries, therefore the USA and the UK play a prominent role in the description of the practice applied; nevertheless, I shall also touch upon the international and Hungarian accounting dimensions of the issue. In addition to the presentation of the past and the present, I will also mention some topical issues of the day, such as the aligned revision of financial reporting statements by IASB and FASB (IASCF [2008], IFRS Foundation [2010]).

For the purposes of these subject matters, I will review the empirical research in three fields: stakeholders and their information needs, the regulation of accounting statements, and the informative value of cash flow data.

Regulatory frameworks strive not to express any overt setting of priorities among stakeholders, but practice proves that they consider the owners to be the main addressees of financial reporting, followed by fund providers and creditors (Benedict–Elliott [2001], Lakatos [2009]). In smaller companies, the individual stakeholders' roles may overlap, or part of them may not appear at all; for instance if no creditor exists, less interest is displayed concerning those parts of the report which depict the changes in the financial position, such as the cash flow statement. The differentiation of accounting rules on the basis of company size is present in every framework; as far as the statement of cash flows is concerned, it tends to represent that larger companies are obliged to present one, while smaller entities are not.

Although similar users' needs have to be fulfilled in the framework of financial reporting all over the world, national idiosyncrasies tend to substantially influence the evolution of national accounting regulation systems. Based on these differences, a well hierarchised system of national frameworks may be established (Nobes–Parker [2008]). Due to the expansion of globalisation and international accounting, these differences continuously decrease (convergence, harmonisation), and have been shown to be smallest in the field of cash flow statements in particular (Purvis–Gernon–Diamond [1998], Bae–Tan–Welker [2008], Beke [2010]). As international accounting becomes ever more widespread, differences due to regulations disappear; yet as a result of a certain resilience of the framework, the actual practice has not become really unified, and minor differences persist between the various countries (Nobes [2011]).

The utility of cash flow data had been researched even before cash flow statements became mandatory elements of financial reports (see e.g. Bowen–Burgstahler–Daley (1987]). The respective studies mostly covered listed companies, especially is the USA. Every research found that cash flow data possess measurable utility and increase the precision of future estimates concerning the entity.

Similarly to the description of empirical research, I organised the hypotheses of my dissertation around three main subject matters. My progress compared to earlier research lies in the fact that i) no such analyses have yet been performed for the Hungarian context (the relationship between stakeholders' needs and Hungarian cash flow regulations, and the relationship between income and cash flow data and security returns), and that ii) as opposed to international studies which had a wide scope but remained on the surface, I performed an analysis which is more restricted in scope (limited to the field of cash flow only) but goes deeper in the details. The chapter will also present the data collection and databases I drew upon to test my hypotheses, verifying my assertions using mathematical/statistical methods.

The aim of my dissertation is to contribute to the development of the regulation and practice of cash flow statements in Hungary. I will summarise the conclusions drawn from the analyses in a closing chapter.

2. Foundations and formulation of the research hypotheses

In my dissertation I have presented the role of cash flow statements in the accounting statements, touching upon three issues: stakeholders' needs concerning the incremental information content of the cash flow statement, coherence of and differences in national and international cash flow statement regulations, and the informative value of cash flow statements concerning security returns.

Survey findings show that the compilation of cash flow statements tends to cause many problems in practice, and sometimes the reliability of the data they contain may also be questioned; therefore the correct presentation of a cash flow statement is very resource intensive. Based on the principle of cost versus benefit, a statement may be considered useful if the benefits on the user side outweigh the costs of compilation. According to the current Hungarian regulations, cash flow statements are only mandatory in annual reports, and not so in the simplified versions. I assume that the regulation is in line with Hungarian practice. I intend to examine this assumption in the form of three sub-hypotheses:

<u>Hypothesis H1:</u> **Hungarian regulations are in line with the applied practice, representing that stakeholders able to retrieve incremental information from cash flow statements in accounting statements are present (to a substantial extent) in larger companies only.**

In a first step I will examine to what extent creditors as stakeholders—one of the main players, beside owners, who share an interest in the information needs related to the changes in the financial position of the firm—are present in different types of companies. I assume that this player is less determinant in smaller companies, and that creditors are more important in the case of larger entities.

<u>Hypothesis H1/a:</u> **In Hungarian practice, the proportion of outside funds, indicative of the involvement of creditors as stakeholders, compared to the balance sheet total is significantly lower in smaller entities than in larger companies.**

Hungarian regulations in force only request enterprises preparing an annual report to obligatory include a cash flow statement in their reports. Companies preparing a simplified annual report shall also report on the changes in the financial position of the entity in the notes, but no methodological constraints are imposed for doing so. I assume that companies preparing a simplified annual report prefer to use simpler indicators for the presentation of their financial position, and do not typically tend to compile a cash flow statement which is rather more complex and more costly to prepare.

Hypothesis H1/b: **Hungarian companies not obliged to prepare a cash flow statement typically do not choose to use a cash flow statement to present the changes in their financial position in the notes.**

The Hungarian annual report obligatorily contains a statement of financial position, an income statement and the notes, and in particular, as part of the latter, a cash flow statement. However, the cash flow statement is only useful for the users of the report if it provides incremental information. I assume that cash flow statements do provide incremental information in addition to the statement of financial position and the income statement.

Hypothesis H1/c: **Cash flow statements in Hungarian annual reports provide the users with incremental information which may not be generated from the data in the balance sheet and the income statement.**

When describing the international research into cash flow statements, I have shown that on the surface, both national accounting frameworks and national practices followed in the framework of the common regulations (IAS/IFRS) seem to have many features in common. However, I assume that the analysis of the details related to cash flow statements reveals many deviations, which allows us to classify the countries in hierarchical groups. I shall examine this hypothesis in two separate parts: first, the national regulations, and second, the national practices followed within the common regulatory framework (IAS/IFRS).

<u>Hypothesis H2:</u> The national regulations of individual countries concerning cash flow statements and the national practices followed within the common regulatory framework (IAS 7) differ in their details, and countries can therefore be classified in hierarchical groups.

Discussing research into the accounting regulations of the various countries, I established that as a result of their particularities, different countries have established partly different frameworks. Studies with inductive approaches typically encompass a wide range of regulatory issues, but based on a limited number of factors only. In the case of statements of cash flows, most studies have so far only examined the existence of rules governing the presentation of the statement, without an in-depth analysis of the details. Therefore, these studies only found relatively minor differences in this field. I assume that many differences exist between national cash flow statement regulations, which makes it possible to classify the countries in hierarchical groups.

<u>Hypothesis H2/a:</u> Individual countries may be classified in hierarchical groups based on the details of their national frameworks governing the presentation of cash flow statements.

Earlier international studies found that as a result of the increased flexibility provided by the IAS/IFRS reporting system, each country decided to implement in its own practice the solutions which were closest to their original national frameworks; therefore these differences have partly persisted despite the use of an identical regulatory framework. I assume that many differences exist in the IAS 7 cash flow statement regulations as applied by each country in practice, which makes it possible to classify the countries in hierarchical groups.

<u>Hypothesis H2/b:</u> Individual countries may be classified in hierarchical groups based on the details of their national practices applied in relation to the IAS 7 cash flow statement.

Researches into the informative value of cash flow data have discussed their future forecasting ability and their relationship with security returns. Each study concluded that cash flow data possess incremental incremental information content in themselves as well as relative to the earnings. I assume that this relationship also exists in the case of Hungarian listed companies.

Hypothesis H3: **The operating cash flow of Hungarian listed companies shows a significant relationship with the security returns, as considered individually as well as incrementally relative to the earnings before taxes.**

3. Methods used and research findings

The Hungarian regulations in force stipulate that entities should present the changes in their financial position in the notes attached to the report. The method to do so is only specified in the case of the annual report, which shall obligatorily comprise a cash flow statement; however, no such rule exists for simplified annual reports. Cash flow regulations have been introduced in Hungary only recently; the cash flow statement became a mandatory part of the annual report as late as in 1997, and ever since, there has only been a minor amendment to this rule as part of the recodification process of the Accounting Act (some additions to the form and provision of explanations); therefore we may consider that the present regulation is still the amended version of the first framework. My research examines the situation relative to cash flow statements in Hungary (regulation and practice) based on some hypotheses established in relation to three subtopics.

The first hypothesis approaches the issue from the aspect of utility, and analyses whether the regulatory framework is in line with the existing practice in Hungary. Information concerning changes in the financial position are the most important, of all other stakeholders, for creditors[1] in particular. Consequently, the generation of such information may only deemed useful if any stakeholders actually need it.

The Accounting Act imposes the obligation to prepare a cash flow statement on the basis of the company size; consequently in Hypothesis H1/a, I analysed the existence of creditor liabilities after dividing the company population into two parts on this basis. The variance analysis shows that creditors as stakeholders are present in a significantly smaller proportion of smaller companies than in the case of larger firms. This is primarily confirmed by the median of the various liability ratios: in a narrow sense of the term, creditors' liabilities are not present at all in more than half of smaller companies, and even in the broad sense, it exists in a much lower proportion than in larger firms. This suggests that the differentiation based on size is justified; however, another research might examine whether the value limits are well established in this respect, or if it may be necessary to include other factors (e.g. ratio of creditors' liabilities) in the differentiation concerning the applicable rules.

[1] Also including suppliers in the broader sense of the term.

In Hypothesis H1/b, I examined the presentation of changes in the financial position through the analysis of the existing practice. Experience shows that entities preparing a simplified annual report do not typically disclose a cash flow statement on a voluntary basis; a substantial part of them (37%) fail to present the simplest indicators, which actually constitutes an infringement of the Accounting Act. Also many companies compiling an annual report fail to respect the legal provisions: 30% have not included the mandatory cash flow statement in their disclosed reports, and (what is even more serious) in most of these cases (69%), even the audit failed to point out this shortcoming. As far as our research subject is concerned, we need to draw the conclusion that statements are probably defective in both categories because there is no stakeholder who would otherwise enforce the presentation of the statement in question; or else such stakeholders exist but access the information they need in another way, outside the framework of the report, for instance in the form of data required for the assessment of the credit requests. My analysis only covers creditors' as stakeholders' needs, and excludes the examination of the reasons of the above mentioned shortcomings, which could constitute a distinct line of research.

Disclosed data only become information in case they possess added value for the user. Accordingly, the presentation of a cash flow statement is only useful if the data it contains provide usable incremental information compared to the other parts of the report. This constituted the subject of my research in Hypothesis H1/c. With respect to the statements in general, in some cases (1.9%) logical contradictions may be detected, meaning that the disclosed cash flow statement is quite probably incorrect. In this case the question arises whether it is not worse to disclose a cash flow statement which contains erroneous data than not to disclose one at all, as it misleads the users of the report (in two cases, even the audit failed to detect the seriously erroneous data). My analysis found that when using the direct method (partly as a result of the method), the majority of the lines in the investing and financing categories contains new information, while the operating part rather presents data which may be deduced from the balance sheet and the income statement, i.e. data which are already known or which are transformations of already known data (e.g. changes in the stock from the balance sheet). The lines of the operating part of an indirect cash flow statement, on the other hand, do not necessarily have to be identical with the respective values derived from the other two statements, for corrections need to be applied in certain cases, as referred to in Annex 7 of the Accounting Act (e.g. earnings before taxes have to be displayed in the cash flow statement without the dividend received). Several studies have discussed this issue (c.f. p. 81 of this dissertation).

However, I only examined the existence of such deviations in the reports; I did not have the possibility to analyse the identicalness of the data in the statements and see whether no correction was needed and the values are really identical, or whether correction would have been necessary to present the correct value of the cash flow. A deeper analysis could constitute another possible line of research, but this would necessitate more detailed data than those available in the reports, which I consider might be best acquired by using the method of in-depth interview.

After the description of the situation in Hungary, in Hypothesis H2 I also examined the position of the Hungarian framework and practice in an international comparison.

Most earlier international comparative studies found that there is a pronounced difference between Anglo-Saxon and continental European countries. Further breakdown is possible within the groups, but in this respect the distinctions established by the individual studies are not unequivocal, and the differences within the groups are also less important. The graph accompanying Nobes's hierarchical classification (Nobes–Parker [2008]) is a good illustration of such comparisons. Earlier research encompassed a wide range of regulatory frameworks but only analysed the individual subtopics based on a small number of issues; for instance, in the case of cash flow statements they only examined whether their presentation is mandatory or not. As opposed to this earlier practice, my research analysed a narrow field of regulation—the cash flow statement—but in much more detail, using a questionnaire. I intended to include in my research the 14 countries covered by Nobes as well as Hungary and the IAS/IFRS framework, but throughout the year when I conducted my empirical research, I never managed to find anyone to fill in the questionnaire about Canada and Italy; consequently, I performed the calculations for Hypothesis H2/a based on 14 frameworks altogether. For the purpose of the comparison, I first described the similarities and differences in respect of the 44 questions analysed; subsequently I isolated 4 groups using the method of cluster analysis:

0) No regulation: Belgium, France.
1) Developing: Hungary, Spain.
2) Classic: US, Australia, the Netherlands, IFRS, Japan, Germany, Sweden, New Zealand.
3) Sophisticated: The United Kingdom, Ireland.

Compared with earlier research, it may be established that differences between these countries are relatively smaller in the field of the regulation of cash flow statements, with the majority falling into the category I labelled as ‘classic’. There are, however, marked differences compared with the three remaining groups, although this is due to various factors:

0) In Belgium and France, this field is not regulated.
1) Hungary and Spain do have regulations in this area, but they are relatively smaller in bulk and more rigid than those of other countries.
3) The UK and Ireland (who have a common framework) made two modifications to the classic regime (beginning in 1996) concerning the restriction of the cash basis and the introduction of a more sophisticated classification (eight categories instead of three).

The ongoing revision of the IAS/IFRSs points towards a shift from the ‘classic’ towards the ‘sophisticated’ regime. We may also establish that the division between Anglo-Saxon and continental European regulatory systems is not applicable in the case of cash flow statements.

As a result of the ever extending scope of application of the IAS/IFRSs, international comparative research has recently shifted towards national practices applied in the context of an identical regulatory framework. Listed companies are obliged, in an increasing number of countries, to prepare their consolidated reports according to the IAS/IFRS framework: in these cases, divergences between countries may only be traced back to the practice followed in the given country, as they cannot be influenced by differences in the regulatory frameworks. Here again, studies have examined a broad field in accounting, but based on a limited number of issues per subject matter and in a superficial manner only. These analyses show that the same division into two groups (Anglo-Saxon and continental European countries) applies also from the perspective of the practice (Nobes [2011]). In my dissertation, I limited the analysis to the field of cash flow statements, but have intended to go deeper down into the subject, examining the 9 options (2 formal and 7 content) offered by IAS 7. My research covered the 8 countries examined by Nobes, and I used another model to analyse the version including Hungary too. Overall, I have found that most countries use the basic version suggested by the standard, and alternative options are less frequently used in practice. There was, however, one exception: the method of compilation of the operating category; in this case, almost every country (except Australia) applies the optionally permitted indirect deduction method. After the question-by-question comparison of the applied practice, I made up the hierarchical groups using cluster analysis. In this case, the dendogram yielded the classic distinction between

Anglo-Saxon and continental European countries: the first two countries to separate were Australia and the UK, followed by a group of the six continental European countries, which could be divided into two further subgroups of three countries. The main differences show in the rate of choices between the suggested and alternative options as described below:

1) Only Australia applies the suggested direct method for the presentation of the operating cash flow category in a decisive majority (which only happens sparsely in any other country), and typically keeps to the suggested basic versions in all other cases as well.
2) The UK tends to typically use the optional solutions*.
3) In the Netherlands, Italy and Spain, firms usually use intermediary solutions, but choose the suggested option in a smaller number of cases.
4) France, Germany and Sweden tend to opt for the suggested solutions and only rarely use alternative options*.

* The operating category is an exception to this statement in groups 2 to 4, as virtually every firm chose to apply the permitted indirect approach.

Placing Hungary on the map, the situation remains largely the same: we fall into the continental European group and into the ‘intermediary solutions’ subgroup, but we are somewhat closer to the British practice than the other three members of the same group.

Two directions would be available to continue this research: first, in the scope of countries covered by the study, for example comparing the Hungarian context with the other CEE countries; and second, in-depth analyses could be performed in other fields of accounting.

Many ways are available for the measurement of the entities’ performance: we may use income or cash flow data, or in the case of listed companies, security returns may constitute a good external measure of performance. In Hypothesis H3, I examined the income and cash flow data of Hungarian listed companies in relation to security returns. My analysis embraced the 2005–2011 period for 13 companies, with the calculations based on 78 cases after the elimination of the outliers, necessary because the models used are sensitive to outlier and extreme values. Of all the data used, the values of earnings before taxes and operating cash flow showed the strongest relationship with security returns; consequently I used these indicators for the detailed analyses. I first analysed the individual correlation of the two report data with security return using a correlation analysis regardless of the direction: this yielded a significant weak relationship in both cases. To detect the incremental relationship of the data, I used the partial correlation coefficient: in the case of earnings before taxes, by controlling the cash flow variable, I repeatedly obtained a significant weak relationship; however in the inverse case, such a relationship could not be detected at a generally accepted level of significance. In the relationship analysis, I included the directions and formulated regression models with earnings before taxes and cash flow from operations as independent variables and security returns as the dependent variable. In the case of a two-variable regression (one dependent and one independent), both earnings before taxes and the operating cash flow showed a significant linear (no constant) relationship with the security returns. Including both independent variables at the same time, i.e. building a model with three factors (two independent and one dependent variables) however, I found that in the significant linear equation only the test of the earnings before taxes shows an individually significant relationship, while this is not true for the operating cash flow and the constant term. Based on both analyses, I have concluded that considering the scope of the analysis, earnings before taxes carries, both individually and incrementally, incremental information relative to the security returns, while this holds true for the operating cash flow data only individually, but not incrementally.

I only used data disclosed in the entities' reports for the analysis; however, as a result of the flexibility of the regulation, they did not always use the same classification parameters for the cash flow categories. Another research could examine whether the harmonisation of the existing practice might increase the explanatory power of the model, and the refinement of the model with further variables could be tested in respect of the problematic classification factors. My research only included companies which were listed throughout the 2005–2011 period and also fulfilled every other condition; the analysis could be extended to include companies listed and unlisted during the period. This extension would provide sufficient data even to run the models in an annual breakdown; at the same time, I find that data from 7 years would still be insufficient for a company by company analysis.

4. Summary of conclusions

My dissertation only concerns cash flow statements in accounting statements. However, cash flow statements open up a much wider field and provide good research opportunities either in the field of accounting (e.g. undisclosed cash flow statements for internal purposes only) or even in some borderline issues (e.g. financial or business valuation approaches).

My dissertation described the regulatory frameworks governing, and existing practice of, cash flow statements in accounting statements, also examining the Hungarian context in an international comparison. Based on the research, I found opportunities for improvement of Hungarian regulations and practices in the following fields.

The analysis of creditors as stakeholders has shown that the balance sheet frequently—in the case of half of the small enterprises, but sometimes also in larger companies—does not contain any liabilities towards such entities. The analysis of the disclosed notes has shown that entities frequently fail to comply with the provisions of the Accounting Act and do not present the changes in their financial position and/or fail to disclose a cash flow statement in the annual report. A fraction of the cash flow statements contradict other parts of the report, i.e. are probably erroneous. Both of the above assertions induce me to suggest the consideration of a further restriction of the scope of entities obliged to present a cash flow statement, with regard to the stakeholders' eventual needs in accordance with the cost/benefit principle. Several developed countries (US, the Netherlands, Japan, Germany) apply such a restriction concerning the obligations, and two countries (Belgium and France) don't even have any pertaining regulation—although I personally do not consider this as good practice.

In the comparison of national cash flow statement regulations, Hungary—with its meagre and rigid set of rules—was classified in the 'developing' group. Possible directions of development may be the adaptation of the international framework or a shift towards the regulation of the countries labelled as 'developed' in the research. Progress should be made in two respects: first, a more detailed regulation is needed; second, more freedom should be granted to entities in the presentation of their statements, as is the case in most other frameworks. One such area is the compilation of the category of operating cash flow, where—account taken of the increased information content—the direct method should be at least permitted, or eventually suggested, or in case of a more radical step forward, prescribed with a mandatory effect.

As far as listed companies are concerned, the Hungarian practice in line with IAS 7 is consistent with the practice of Western European countries, and there is no real need for improvement in this respect.

Cash flow statements are frequently affected by structuration problems, and are generally considered to be erroneous on account of these; however, such statements actually reflect the threefold structure of economics (operating, investing and financing), as opposed to the other two statements of the report. This means that the fault is on the side of the balance sheet and the income statement; but as these two receive priority in the course of accounting, and the cash flow statement is only prepared afterwards, the situation appears in an inverse manner. This is exactly the line that the revision of the financial statements performed in the framework of the ongoing joint IASB–FASB project takes; in fact, this is expected to be the future trend in accounting. The question is when the Hungarian regulator and profession intend to follow this trend: whether they fall behind, keep up with, or perhaps take the lead in the process.

Based on the findings of my research, I consider that it would be necessary for all professional players to acquire deeper knowledge concerning cash flow statements; I suggest a utilitarian approach to this process, pointing out the benefits of cash flow statements by way of training, publications and studies. I sincerely hope that my dissertation will contribute to this development.

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Relevant own publications and conference presentation

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