MINUTES

Financial Accounting Standards Board

To: Board Members

From: Debbeler (ext. 353)

Subject: Minutes of the October 7, 2009 Board Meeting: Financial Statement Presentation **Date:** October 10, 2009

cc: FASB: Golden, Bielstein, Lott, Stoklosa, Proestakes, C. Smith, Posta, Chookaszian, Gabriele, Sutay, Petrone, Cafini, Cappiello, Hales, Milne, Debbeler, FASB Intranet; IASB: Leisenring, Gomez, Schmidt, Perkovich

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Accounting Standards Update.

Topic:	Direct method statement of cash flows
Basis for Discussion:	FASB Memorandum No. 68
Length of Discussion:	9:00 a.m. to 10:30 a.m. (Eastern)
Attendance:	
Board members present:	FASB: Herz, Linsmeier, Seidman, Smith, and Siegel IASB: Leisenring
Board members absent:	None
Other participants:	IASB: Board members: Cooper, Engstrom, Gomes; Staff: Gomez, Schmidt, Perkovich (by phone) Outsiders: Paul Zarowin (NYU), Dane Mott (JP Morgan Chase)
Staff in charge of topic:	Hales
Other staff at Board table:	Golden, Petrone, Cafini, Cappiello, C. Smith, Milne, Debbeler

Summary of Decisions Reached:

The Board held an informational meeting with a member of the academic community and a member of the user community and discussed the benefits of the direct method statement of cash flows. This meeting was educational in nature and no decisions were made.

Objective of Meeting:

The objective of this meeting was to address the following questions:

(a) what additional insight is available through a direct-method statement of cash flows that is not available using an indirect method of presentation?

(b) would any of the information that is available using either method be more useful if it were presented in a direct-method format?

(c) is it easier to use and derive information from a direct-method statement of cash flows than from an indirect-method statement of cash flows?

(d) what types of decisions would be most likely to benefit from the additional information?

The objectives of this meeting were met.

Matters Discussed and Decisions Reached:

1. Mr. Hales introduced the meeting and the presenters. Professor Paul Zarowin is a professor from New York University, and he summarized key findings from academic research on presentation of the statement of cash flows (SCF). Dane Mott, a Senior Equity Analyst from JP Morgan Securities and a member of the CFA Institute, represented a user's perspective and discussed what he sees as the key benefits that would accrue to users if the direct method SCF were to be

required. Professor Zarowin prepared slides for use in his discussion, which are available as part of the board handout for this meeting[1].

2. Professor Zarowin stated that he has no bias or opinion regarding the presentation of the SCF and that he is only presenting what he sees as the leading research in the area, none of which was his own research.

3. Professor Zarowin stated that only a few papers have compared the direct and indirect presentation of cash flows, and that he selected what he views as the two most prominent and important papers in the area. Those are:

   (a) Orpurt, Steven and Yoonseok Zang, 2009, "Do Direct Cash Flow Disclosures Help Predict Future Operating Cash Flows and Earnings?", *The Accounting Review*, 84(3), 893-935. [Abbreviated herein as OZ.]

   (b) Krishnan, Gopal and James Largay, 2000, "The Predictive Ability of Direct Method Cash Flow Information", *Journal of Business Finance & Accounting*, 27 (1), 215-245. [Abbreviated herein as KL.]

4. Professor Zarowin explained the samples of the two papers. KL contains a sample of 405 U.S. direct-method observations between 1988-1993. OZ contains a sample of 119 firms and 604 observations between 1989-2002. Professor Zarowin stated that firms do not always produce a direct method SCF, and asserted that occasionally they change between methods.

5. Mr. Leisenring asked for clarification on this point, noting that the major complaint of preparers is that changing between the two methods is prohibitively expensive. Professor Zarowin stated that he did not know how or why these firms were able to change between methods.

6. Professor Zarowin explained that articulation errors cause a user to be unable to obtain exact direct cash flow information from indirect method statements and disclosures. He explained that the studies find direct method cash flow information to be better predictors of future performance (cash flow and earnings) than indirect, and that adding articulation errors back into the indirect method

[1] The handout is available at the FASB's website.

information improves the predictive power of that information. He also explained that stock returns reflect more future earnings and CFO information if the firm uses a direct method SCF.

7. Mr. Linsmeier asked if articulation errors were related to an inability to understand the effects of mergers and acquisitions and foreign currency translations. Professor Zarowin clarified that even when the effect of major restructurings like those Mr. Linsmeier cited were adjusted for, the articulation errors persist.

8. Mr. Herz asked for more detail about the test that would prove "better predictive power." Professor Zarowin clarified that regression models are used where observed future performance (for example, operating cash flow or earnings from period t+1) are used as the dependent variable and various predictive factors (for example, cash flow information from period t) are tested as independent variables. He referred to this method as a "within-sample" prediction. Professor Zarowin clarified that predictions based on indirect information plus articulation errors perform better (result in higher R^2 values, which measures the fit of a regression to the original data) than predictions based on indirect information alone.

9. Mr. Leisenring asked for clarification about why the direct method provides better predictions of future earnings. Professor Zarowin stated that it appears to be that direct method information cannot be recreated from indirect information. He stated that he is not aware of any theoretical reason why direct method cash flows should be better predictors, but that empirically, based on both OZ and KL, they are.

10. Mr. Linsmeier stated that he might posit that direct method cash flow information is a better predictor because "cash received from customers" will provide better information about future "cash received from customers" than other financial information, and that methods to isolate this information from indirect method statements of cash flows are prone to error.

11. Ms. Seidman asked about the source of data that was used to compare direct-method cash flow information to indirect method cash flow information in order to

understand if a system change was done. She expressed concern that using an "indirect-direct" approach to prepare the SCF would not eliminate articulation errors. Professor Zarowin stated that he did not know how the firm prepared the data. Professor Zarowin also stated that one of the results from the studies was that articulation errors varied widely, which he believes is important because if the error were standard among firms, it could easily be corrected.

12. Mr. Smith clarified that an entity would have better information with which to prepare a direct-method SCF using an "indirect-direct" approach. He stated that even if articulation errors could not be avoided by a *user* creating direct method information from the face of the financial statements, the *entity* could come much closer because it has better information. Professor Zarowin and Mr. Siegel agreed.

13. Mr. Linsmeier asked if it was being suggested that the direct method be required and then it would be acceptable for entities to use an "indirect-direct" approach to create the information. Mr. Siegel and Mr. Smith responded in the affirmative.

14. Ms. Seidman noted that the reason the Board was pressing this issue was because cost was a major concern among preparers, and they wanted to fully understand the strengths and weaknesses of various alternatives.

15. Mr. Leisenring stated that he wasn't sure why knowing the exact cash flows from the previous year would help to predict cash flows in the future. Mr. Linsmeier stated that currently only operating cash flow is provided, and that perhaps line items that are required in a direct method and currently not visible, such as "cash from customer" and "cash paid to suppliers," might be more persistent across time periods. He also stated that the breakdown of cash flows provided by the direct method will help users understand which cash flow items are persistent and which are not. Mr. Siegel gave an example of observing trends between "cash from customers" and revenue, and then using revenue forecasts provided by the firm to predict future cash flows with some certainty.

16. Professor Zarowin returned to his slides, continuing at slide 4, and explained that the studies found significant error (as a percentage of total assets) when trying to

reconstruct direct method information (total cash flow, cash received, and cash paid) from indirect method cash flow information or the balance sheet. He reiterated the point made earlier (and included as slide 6 in his presentation) that the articulation errors vary among firms, which means users can't make a fixed adjustment to work around them. He stated that the key point from these findings is that direct method statements are not redundant; that the information cannot be replicated from other information.

17. Ms. Smith asked if any of the specific articulation errors (such as foreign exchange) are more prevalent than others, and Professor Zarowin answered that the studies did not investigate that.

18. Professor Zarowin explained that the studies demonstrated that direct method components produce lower forecast error than indirect method components in a within-sample prediction of future cash flow from operations, and that articulation errors improve the forecasts when they are added to the indirect method information. He stated that these results hold even for firms outside the top 10% of articulation errors.

19. Mr. Mott gave a practical example of how seeing direct cash flow information might improve an analyst's forecasts. He stated that seeing that prepayments are a large component of direct cash flow would indicate that perhaps future cash flows would not be as high because the firm has already been paid for work it is still doing. He also stated that disaggregation among cash outflows can help an analyst apply appropriate growth rates based on different economic drivers, such as labor, raw materials, or commodity costs. He noted that these adjustments can't be replicated using indirect cash flow information.

20. Professor Zarowin explained the tests related to Future Earnings Response Coefficient (FERC) performed by OZ. The study found that firms using the direct method have a higher FERC than firms using the indirect method, which indicates more information about future earnings and cash flows is being incorporated into the current stock price of direct method firms. Professor Zarowin then explained that detailed tests were done to control for self-selection; that is, to ensure that

results related to FERC and the direct method were not due to other factors. The tests showed that higher direct method FERC was not due to self-selection. For example, OZ tested firms that do not always use the direct method to see if the results persist without the direct method. The results do not persist after a firm switches to the indirect method. Professor Zarowin stated that the OZ tests convinced him that it was not something inherent in those firms such that they would have had a higher FERC regardless of reporting choice, and that something about the information provided by a direct method statement of cash flows is causing the observed differences.

21. Mr. Smith asked for clarification about the firms in the sample who apparently used both direct and indirect methods during the sample period. Mr. Zarowin clarified that they did change between methods at least once during the study's time period. Mr. Smith expressed surprise that companies would be able to change between the methods, and Ms. Seidman agreed.

22. Professor Zarowin explained another test that OZ performed to control for self-selection was to perform the FERC tests for the companies in the study for years prior to 1988, which was when a cash flow statement was first required. If the results had been due to self-selection, this test should have found the same difference in FERC among the companies before they created a cash flow statement. The test found no difference in FERC in pre-cash-flow-statement companies, indicating that the choice of cash flow statement method was the cause of the differences.

23. Mr. Mott began his portion of the presentation. He noted several items of difference between indirect and direct method statements. He noted that one flaw he perceived in the indirect method is that it is not intuitive; that it does not represent a "story." He noted also that there were many adjustments and allocations that cause him to question the accuracy of indirect method statements, such as foreign exchange, securitizations, or mergers and acquisitions. He noted that the percentage of completion revenue recognition model caused revenue and cash flow to be disconnected, and that direct method information can provide

additional information about which amounts are prepayments or current payments. He noted that analysts value being able to create ratios with direct cash flow information and being able to compare cash earnings to revenue over time or within an industry.

24. Mr. Mott noted that he had found an S&P 500 aerospace company that provides both indirect method and direct method cash flow statements. (He added that he would prefer more disaggregation than was provided in that company's direct method statement of cash flows.) He identified several instances in this particular example where the direct method statement provided better information: (a) percentage of completion, (b) insurance proceeds, (c) litigation, and (d) noncash transactions such as pension contributions. He noted that the Board had the opportunity to improve market efficiency by increasing the amount of information available.

25. Mr. Mott expressed support for a balance sheet to balance sheet reconciliation, stating that he believed it achieved the goals of the project as articulated in the discussion paper, *Preliminary Views on Financial Statement Presentation*. He stated that he believed increased information would help analysts avoid "dead ends," where they could not fully perceive the effects of a transaction, and that it would help analysts understand better how to create models of all the financial statements. Mr. Mott noted that he included in the meeting materials a June 2006 report from Bear Stearns identifying ways to improve cash flow information and the CFA Institute survey regarding the statement of cash flows, wherein a great deal of support was expressed for the direct method.

26. Mr. Herz asked how far the idea should be taken, imagining a complicated company with numerous segments and products. He asked if perhaps the majority of the benefits outlined could be obtained with some subset of the changes suggested. Mr. Mott stated that he admittedly preferred that the Board make the full set of changes, and advocated pushing direct method cash flow statement preparation down to the segment level as well as the balance sheet to balance sheet reconciliation. He noted that a diversified, complicated company should not be

asked to present less information for that reason, as that complexity is what would demand increased information.

27. Mr. Smith asked if there were specific accounts where direct cash flow information would be most useful and where targeted requirements might be most important. Mr. Smith noted that cost to preparers was also an important piece of the Board's deliberation.

28. Mr. Linsmeier asked if direct method cash flow information was included in a balance sheet to balance sheet reconciliation, and noted that Mr. Mott admittedly focused on a subset of accounts (namely, those that persist) but probably could not be prescriptive about which ones. Mr. Mott agreed that the cash flow information he was looking for would be included in a balance sheet to balance sheet reconciliation, and that the cash flow information needed to be prepared with the direct method in order to meet the requirements. Mr. Linsmeier suggested keeping the indirect cash flow statement and requiring the balance sheet to balance sheet reconciliation, and asked Mr. Mott if there would be a way of prescribing which accounts were most useful. Mr. Mott acknowledged that it was difficult to prescribe which accounts were important, but expressed support for including at least working capital accounts.

29. Mr. Siegel attempted to construct a scenario that would be "good enough." He suggested requiring information about the key drivers of cash flows, plus a provision that significant one time inflows or outflows be disaggregated. Mr. Mott noted that disaggregation was one of the most important pieces of the requirement, and finding the point at which the information was disaggregated "enough" was difficult.

30. Mr. Linsmeier asked if financing was important for the reconciliation schedule. Mr. Mott answered yes, and noted that a lot of financing cash flow information is already provided on a direct basis. Mr. Linsmeier stated that he believed a reconciliation schedule was overly challenging, and noted that the reconciliation loses account-specific information because of standardized columns. He stated that he was leaning towards prescribing individual rollfoward schedules for key

balance sheet accounts, to provide a more customized look at each account. Mr. Mott noted that developing these principles might be difficult because it would be necessary to drill down to specific companies and industries to find the most meaningful accounts.

31. Mr. Smith noted that both approaches contained flaws. He noted that Mr. Linsmeier's concern is that a standardized reconciliation leaves out information that will otherwise get buried, and noted that Mr. Mott's concern is that identifying specific accounts will result in something being left out.

32. Ms. Seidman stated that she believed some changes, such as requiring increased disaggregation in an indirect method statement of cash flows, would be "low-hanging fruit." She noted that some of the difficult issues Mr. Mott identified, such as derivatives, insurance proceeds, and noncash changes in fair value, could be included as specific line items in an indirect cash flow statement. She stated that this might help to resolve the confusion surrounding those items. Mr. Mott agreed that increased granularity would help analysts do their job.

33. Ms. Seidman explained a rationale that she had heard from preparers at the FASAC meeting as to why this change was so difficult. The preparers had explained that their general ledger information does not contain cash flow information. Ms. Seidman noted that modifying a system to include this information, especially down to the subsidiary level, would be a difficult undertaking. Mr. Mott noted that even though the modifications were challenging, they might provide useful information to the preparers. Ms. Seidman noted that she had heard preparers at the meeting say that if they had thought this information was important, they would have already been creating it.

34. Professor Zarowin wondered which cost was smaller: the cost of efforts and errors by the analysts or the implementation and systems changes costs of the preparers. He noted that he thought it might be less costly on the preparers' end. Mr. Herz noted that there was a "network" benefit to making the changes and improving financial information, but that preparers would have to make a significant expenditure to make the improvements.

Follow-up Items:

None.

General Announcements:

None.