NUOVE FRONTIERE DEL REPORTING AZIENDALE

La comunicazione agli *stakeholders* tra vincoli normativi e attese informative

a cura di
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Società Italiana di Ragioneria e di Economia Aziendale

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1.1. Introduction

Even if the information content of earnings in explaining a firm's performance, over finite intervals, is generally considered superior to that of cash flows, (Dechow, 1994), cash flows, and especially cash flow from operations, play a relevant role in company valuation (Damodaran, 2006; Guatri and Bini, 2009; Koller, Goedhart, and Wessels, 2005), and in analysts' studies (Allegrini, Giorgetti, and Greco, 2014; Block, 1999; Broome, 2004). Cash flows are often considered by analysts to be more reliable and objective than earnings, because they are not affected by accounting policies and are supposedly immune from earnings management (Broome, 2004). "Cash is king" is a common catchphrase that exemplifies in a simplistic but effective manner this attitude among many users of financial information. Operating cash flows play a special role in this context, given how they are often opposed to net earnings by analysists to assess how "real" the firm's earnings are (Lee, 2012).

Despite this apparent objectivity of cash flows, they are not immune to a certain degree of judgement, or even manipulation; the very definition of "operating cash flow" is open to debate, and so is, generally, the distinction between operating and financing activities in financial reporting (Barker, 2010). In fact, even in contexts where preparers have very few options in the classification of cash flows in the three sections of the cash flow statement (operating, investing, and financing), such as under US GAAP, there is evidence of manipulation of operating cash flows. Previous research showed that manipulation of operating cash flow is distinct form earnings management, and that the timing and the reclassification of items within the cash flow statement can inflate cash flows from operations (Lee, 2012). Even within the boundaries of GAAP, in fact, managers can exercise some discretion on choosing in which section of the cash flow statement (operating, investing, or financing) to report an item, when the classification rules are vague (Nurnberg, 2006).

1.2. Distinguishing between operating and financing cash flows

The operating-financing distinction is pervasive in finance literature, and it can be traced back to the seminal work of Modigliani and Miller (1958), whose model, under the assumption of perfect financial markets and fixed capital expenditures in each period, shows how the value of the firm is not affected by its capital structure. Accounting standards generally require the separate

reporting in financial statements of flows and obligations arising from the provision of finance to the firm, from those, called (in a broad sense) "operating", deriving from all the other activities (Barker, 2010). However, this residual definition of operating activities in financial reporting has been a source of interpretative doubts and different practices. International Financial Reporting Standards (IFRS) too concede that the definitional issues are not clear; IAS 7 – Cash flow statements defines financing activities as those resulting "in changes in the size and composition of the contributed equity and borrowing of the entity", without providing a definition of borrowing (IAS 7.6). IAS 7 states that interest paid and received "are usually classified as operating cash flows for a financial institution" but that there is "no consensus on the classification of these cash flows for other entities" (IAS 7.33). The standard thus allows firms to report cash flows from interest paid, interest received, dividends paid, and dividends received in the operating, investing, or financing section of the cash flow statement (IAS 7.31). Other accounting standards, such as US GAAP (ASC 230) and Italian national accounting standards (OIC 10.41) prescribe instead a more rigid classification of cash flows, requiring to report cash flows from interest paid, interest received, and dividends received as operating cash flows. Reporting outflows from interest expenses in the operating section of the cash flow statement can generate several inconsistencies and generally contradicts finance literature (Nurnberg, 1993; Nurnberg and Largay, 1998). One notable example of these inconsistencies is the treatment of zero-coupon bonds issued by the preparer: the repayment of this financial instrument generates a cash outflow for financial activities, which includes the principal and the interest portion of the liability. Other forms of financial debt, instead, generate payments of interest reported in the operating section of the cash flow statement. Reporting interest payments as operating cash outflows, moreover, can constitute a hindrance for analysts attempting to compare the performance of firms making different financing choices, considering that dividends paid are generally included in the financing section of the cash flow statement (Weiss and Yang, 2007).

The flexibility offered by IFRS to preparers of financial statements offers therefore an opportunity to managers to improve operating cash flows, by reporting payments of interest in another section of the cash flow statement. Manipulation of cash flow can of course also happen with regard to interest and dividends received; however, interest paid are generally a more relevant item in non-financial firms' financial statements. Moreover, it is reasonable to assume that managers can exercise greater discretion in the magnitude and timing of cash outflows for interest payments, rather than in the timing and

amount of cash inflows for dividends and interest (Gordon, Henry, Jorgensen, and Linthicum, 2017).

The flexibility offered by IFRS contrasts starkly with the uniformity imposed by other financial accounting standards, especially US GAAP (but also, as already noted, Italian accounting standards). The introduction of this mandatory classification of interest payments in the cash flow statements into US GAAP by SFAS 95 in 1987 was preceded by a debate on the opportunity to classify cash flows related to interest and dividends as operating (SFAS 95 Basis for conclusions, 88-90). The most evident benefits of this mandatory classification reside in an enhanced intra-company comparability, and in a more direct connection between the operating section of the cash flow statement and the income statement. The position of the IASB on the matter is a source of further complexity for preparers and users of financial information alike: by allowing complete discretion on the classification of cash flows from interests and dividends, IFRS allow preparers to adhere to the definition of operating cash flow that is closer to their view and interpretation. On the other hand, users of financial information, given the generally low degree of additional disclosure that characterizes the cash flow statement, risk not to realize that managers made specific choices in the classification and presentation of cash flow items. The variety of options offered by IFRS makes therefore compelling to understand the reasons that drive managers in choosing one alternative over the other. Investors and other users of financial information, in fact, value comparability among firms, especially within the same industry. Previous studies, conducted on Korean companies that switched to IFRS (Baik, Cho, Choi, and Lee, 2016), and on a sample of European companies (Gordon et al., 2017), showed that classification choices that enhance operating cash flows can be determined by the firm's financial solidity, financial distress, financial leverage, industry, and ownership structure. More in detail, Baik et al. (2016), using a set of Korean firms that switched from local GAAP to IFRS, found that financially distressed firms, firms with high interest payments, firms with more than 5% bank ownership, and Chaebol[1] affiliated firms tend to shift their interest payments from operating to financing cash flows, thus improving their operating cash flow, when compared to local South Korean GAAP requirements (similar, in this instance, to US GAAP). Gordon et al. (2017) study a sample of 798 non-financial firms in 13 European countries, including 45 Italian companies, finding that firms with a higher likelihood of financial distress as well as

[1] A *Chaebol* is a South Korean large industrial conglomerate controlled by an owner or family.

those that issue more equity, have higher leverage, and are less profitable are more likely to make OCF-increasing classification choices.

1.3. Research design and results

We study the consequences of the flexible classification offered by IAS 7 by analyzing the cash flow statements of all the non-financial companies listed on the Italian stock market, and reporting under IFRS. We choose to analyze this sample because we assume that, for companies based in a weak equity country (Nobes, 1998), where the role of debt financing is relevant, interest payments may be an important item in their cash flow statement. Therefore, we expect their classification choices to affect the cash flows presentation considerably. Previous research showed that IFRS choices are mostly driven by the prevailing practice in the country of origin of the firm, often based on rules stated by national accounting standards effective before the introduction of IFRS (Stadler and Nobes, 2014). In the case of the classification of interests and dividends, we do not have a specific expectation on what the prevailing classification choice would have been. In fact, before 2014 Italian GAAP offered a classification choice similar to IAS 7, so the decision to include interest paid and received, and dividends received, in the operating section of the cash flow statement was made after the introduction of IFRS in Italy (in 2005). It is also worth observing how the Italian law introduced the obligation to prepare a cash flow statement for companies not adopting IFRS only starting from the 2016 annual reports (art. 2423 of the Civil Code).

Our sample comprises all the Italian non-financial companies listed on the Italian Stock Market (Borsa Italiana) that report under IFRS. The data were partly hand-collected from the 2016 consolidated financial statements, and partly downloaded from the Mergent Online database[2].

[2] Mergent Online reports financial statements in their original format, without reclassifications. The database, however, does not cover the totality of companies listed in Italy, hence the need to hand-collect data for most of the companies in our sample.

Table 1 – Composition of the sample

	N	%
Companies listed on the Italian stock market as of March 1, 2018	348	100%
Less: banks, insurance companies, and other financial institutions	40	11.49%
Less: foreign registrants	29	8.33%
Less: companies reporting under Italian GAAP	34	9.77%
Less: companies undergoing liquidation or bankruptcy procedures	8	2.30%
Less: companies with missing or incomplete data	15	4.31%
Total companies in sample	222	63.79%

We exclude banks and insurance companies from our sample, because the format of their financial statements is subject to further regulation[3], in addition to that of IFRS. Therefore, we cannot not use them to investigate about flexibility in the classification of cash flows, because of the fixed financial statements format required by regulators. We also exclude foreign registrants in the Italian stock exchange, in order not to include cross listings of companies whose main financial market is other than the Italian stock market, because we want to focus our study on companies influenced by Italy's economic and social environment (Stadler and Nobes, 2014). Finally, we exclude from our sample companies reporting under Italian GAAP in 2016 (for the most part, companies listed in the AIM section of the Italian Stock Market[4]), companies undergoing liquidation or bankruptcy procedures (for lack of data), and companies for which a complete set of financial statements was not otherwise available.

Out of the 222 companies comprising our sample, 44, or 19.82% of the total, classify payments for interest expenses in the financing section of the cash flow statement (Table 2). The remaining companies are equally split between companies reporting interest payments in the operating section of the cash flow statement, and companies not disclosing the classification of interest payments in their cash flow statement. None of the 44 companies that classify interest payments as financing activities report interest or dividend receipts as operating activities, thus showing a considerable consi-

[3] Financial statements of Italian banks and other financial institutions are regulated by IFRS and by provisions issued by the Italian Central Bank (Banca d'Italia). Financial statements of insurance companies are regulated by IFRS and by the Italian Institute for Insurance Supervision (IVASS).

[4] The *AIM Italia* section of *Borsa Italiana* is devoted to Italian small and medium enterprises, and it is reserved to specialized investors. Companies listed in this market can choose to prepare their financial statements under IFRS, Italian GAAP, or US GAAP.

stency in their classification choices. It is interesting to observe that such a choice would have the most beneficial impact on operating cash flows, maximizing the effects of cash flow manipulation offered by the flexibility offered by IAS 7.

Table 2 – Classification choices for interest payments

	N	%
Companies reporting interest payments as operating activities	89	40.09%
Companies not disclosing the classification of interest payments	89	40.09%
Companies reporting interest payments as financing activities	44	19.82%
Total	222	100%

A considerable portion of companies in our sample do not disclose the classification of interest payments in the cash flow statement[5]. Moreover, all companies in our sample, but one, calculate operating cash flows using the indirect method, thus making their classification choices in many cases more difficult to appreciate. However, since all companies in our sample report interest expenses in the income statement, we include those not disclosing the classification of interest payments in the cash flow statement among companies classifying interest payments in the cash flow from operations. It is reasonable to assume, in fact, that companies choosing to classify interest payments as financing activities would disclose this item separately in the cash flow statement.

Tables 3 and 4 show the classification choices for interest receipts and dividend receipts.

Table 3 – Classification choices for interest receipts

	N	%
Companies reporting interest receipts as operating activities	46	20.72%
Companies reporting interest receipts as investing activities	29	13.06%
Companies reporting interest receipts as financing activities	19	8.56%
Companies not reporting or not disclosing interest receipts	128	57.66%
Total	222	100%

[5] While IAS 7 requires to disclose the amount of interest paid, there is no requirement to disclose how interests are classified in the cash flow statement.

There are 29 companies in our sample that report interest receipts in the investing section of the cash flow statement, while 19 companies chose to classify interest receipts as cash inflows from financing activities. The latter choice can be explained by the fact that, in these cases, the financing section of the cash flow statement reports the net amount of interest collected and paid.

Table 4 – Classification choices for dividend receipts

	N	%
Companies reporting dividend receipts as operating activities	22	9.91%
Companies reporting dividend receipts as investing activities	29	13.06%
Companies reporting dividend receipts as financing activities	4	1.80%
Companies not reporting or not disclosing dividend receipts	167	75.23%
Total	222	100%

The majority of the companies in our sample do not report dividend receipts separately in their cash flow statement; 22 companies (9.91%) report them as operating activities, and 29 companies (13.06%) as investing activities. It is interesting to note that four companies in our sample decided to report dividend receipts as cash inflows from financing activities. This classification choice, although admissible under IAS 7, cannot be considered fully consistent with the objective of determining the most correct amount of the financing cash flow. In fact, dividend receipts, arising from equity investments in other companies, should be considered operating or (better) investing cash flows, because they clearly have no relation with the contributed equity and the borrowing of the entity.

All companies in our sample report payments of dividends as a cash outflow from financing activities.

It is also interesting to observe that, although IAS 7 does not require a separate disclosure of the classification of interests and dividends in the cash flow statement, it does require a separate disclosure of the amount of payments and receipts for interest and dividends (IAS 7.31). However, out of the 222 companies comprising our sample, 71 companies, or 31.98%, do not comply, in full or in part, with this requirement, making it impossible to determine the relative weight of interest payments on the cash flow from operations.

In order to appreciate the effects and the magnitude of the classification choices made by the 44 companies in our sample that decided to report interest payments in the financing section of the cash flow statement, we

recalculated a "benchmark" cash flow from operations, by subtracting interest payments and adding back interest and dividends received to the reported operating cash flow. By naming this formulation of operating cash flow as "benchmark", we do not imply that classifying interests and dividends is the most correct choice; instead, we wanted to measure the effect of these classification choices, in comparison with prevailing practice of the other Italian companies adopting IFRS.

The minimum adjustment to the benchmark operating cash flow generated by the classification choices made by the 44 companies is -€2.237. As a percentage, the minimum adjustment is -14.02%, meaning that the reported operating cash flow is lower than the "benchmark" we recalculated. The reclassification choice, therefore, generates a negative effect, decreasing, instead of improving, reported operating cash flow.

Table 5 – Summary of the effects of the classification choices

	Min	Max	Average	Median
Total adjustments, €000	(2,237.00)	433,555.00	24,617.63	3,635.50
As a % of the benchmark OCF	-14.02%	701.86%	37.19%	10.90%

This effect appears only twice in our sample, and can be explained by the prevalence of interests and dividends received, originally classified as cash inflows from investing activities, over payments for interest. In absolute values, the minimum adjustment is €19,000; as a percentage of the benchmark operating cash flow, the minimum difference between the reported and the benchmark operating cash flow is 1.94%. The average effect of the classification is €24,617,630; as a percentage, the reported operating cash flow increases by 37.19% over what would be reported by classifying interest payments as cash outflows from operating activities. In one case, the amount of interest classified is so relevant that the reported operating cash flow improves by 701.86%. In other two cases, the effect of the classification is greater than 100%. The largest adjustment, in absolute value, equals to €433,555,000, amounting to a 62.50% increase in the reported operating cash flow.

The 44 companies that report interest payments in the financing section of the cash flow statement belong to a variety of industries[6], as it is shown in Table 6. We follow the industry definitions of Barth, Beaver, and Landsman

[6] Other industries, not represented in Table 6, but observed in our sample are: mining and construction, chemicals, pharmaceuticals, extractive industries, computers, transportation, retail, and other.

(1998), slightly modified to separate from the service industry companies involved in ICT (information and communication technology)[7].

Table 6 – Companies classifying interest payments as financing activities, by industry

Industry	No. of companies	% of sub-sample	% of industry
Durable manufacturers	12	27.3%	21.1%
Services	8	18.2%	24.2%
Textiles, printing and publishing	6	13.6%	27.3%
Utilities	5	11.4%	26.3%
Financial services	5	11.4%	41.7%
Information and Comm.Technology	4	9.1%	16.7%
Food	3	6.8%	30.0%
Real estate	1	2.3%	11.1%
Total	44	100%	

About 41.7% of companies in the financial services industry, and 30% of those in the food industry, classify interest payments as financing activities in their cash flow statements. Noteworthy percentages can also be observed in the textiles, printing and publishing, utilities, and services industries. Financial services companies are also those that exhibit the largest average effect of the classification, as a percentage of the benchmark operating cash flow (+146.51%), because the company with the largest adjustment in percentage (+701.86%) belongs to this industry.

In order to determine whether the classification choice made by the 44 companies in our sample can be an example of deliberate improvement of the operating cash flow, we ran a logit regression on all the 222 companies belonging to our sample, setting the classification choice as the dependent variable. We are especially interested to check whether the financial leverage of the firm, or the relative amount of interest payments could explain the classification choices made the companies in our sample. The model is the following:

$$Classification = \beta_0 + \beta_1 ROA + \beta_2 Assets + \beta_3 Leverage + \beta_4 Int\_expense + \beta_5 US\_listing + \varepsilon$$

[7] We also renamed the "Insurance and real estate" industry to "Real estate", because our sample does not include insurance companies. For a similar reason, we renamed the "Financial institutions" industry to "Financial services", because banks are excluded from our sample.

Our dependent variable, Classification, is an indicator variable: one if interest payments are classified as financing activities in the cash flow statement, zero otherwise. The independent variables are: debt to assets ratio as an indicator of financial structure (Leverage), return on assets for profitability (ROA), interest expenses by operating profit ratio to measure the relative weight of interest expenses (Int_expense), natural logarithm of the assets for size (Assets). Finally, we expect companies cross-listed in the United States financial markets to conform to US GAAP requirements when exercising IFRS options. Therefore, we introduced a dummy variable (US_listing) to include this information in our model (one if listed or traded in the United States of America, zero otherwise)[8].

We used the ratio of debt to assets, instead of the financial leverage (debt over equity) because 6 companies reported a stockholders' deficit in 2016, making this ratio negative. Moreover, since not all companies disclose the amount of interest paid, we used instead the interest expenses reported in the income statement for our model.

The results of the regression (not shown) are not statistically significant for all the variables in our model. Therefore, we cannot conclude that we find evidence of any tendency to reclassify interest payments out of the operating section of the cash flow statement in presence of high financial leverage, or when the relative weight of the interest expenses is particularly relevant.

1.4. Conclusions and suggestions for further research

As seen in the previous paragraph, the majority of Italian companies report their interest expenses as an operating outflow, normally using the so-called indirect method and often without explicitly displaying, in the cash flow statement, the amount paid for interest during the period. Therefore, there seems to be a significant lack of attention to the distinction between operating and financing activities, contrary to what is fervently suggested by the finance literature. One possible explanation of this phenomenon could be linked to the way Italian company traditionally finance themselves. In Italy, a significant numbers of companies have a weak capital position (insufficient levels of risk capital) and rely intensely on borrowing. In such a context, a remarkable percentage of the borrowing is provided to the firm directly form the supplier, or it is linked to self-liquidating short-term trade financing

[8] There are 40 companies in our sample that are listed on U.S. financial markets, or whose ADR (American Depositary Receipts) are traded over the counter in the United States.

transactions connected to the exchange of goods or services. The distinction between those two different forms of financing could be perceived as somehow fuzzy and could mistakenly lead to ascribe to operating activities the cash inflows and outflows normally linked to the second one. Another reason that could explain the inclusion of interest disbursement in the operating area is probably linked to some cultural repercussions of evaluation methods once used preeminently in Italy. The techniques for evaluating a company normally used in Italy up until a decade ago come directly from the "income system" approach devised by Gino Zappa, the founder of "Economia Aziendale", or business economics (Zappa, 1950).

The theoretical background provided by this approach leads to the use of evaluation procedures and techniques that clearly refer to the so-called "equity side" perspective, in which the value of the firm is derived through the discounted value of future net income flows. The combination of these two facts leads to the inclusion of income expenses in the amount of "net economic benefits" that normally are discounted in order to obtain the current value of the firm.

The prompting effect of an accounting system that deliberately derives its logic from the analysis of the process of formation of "income" probably could explain also why in Italy there is still a remarkable preference for the information contained in the income statement, while up until recently there has been a relatively lower attention to intelligence that could be provided by the analysis of the cash flow statement. The strong theoretical tradition of "Economia Aziendale" could have played, therefore, an unforeseen role in the preference expressed for a long time by practitioners for income statement information, as opposed to the use of cash flow analysis as a tool for gauging the ability of an enterprise to generate new value, and as a way of assessing its financial position. Whatever was the source of this disfavor towards cash flow analysis, its effects are still evident, even if their importance is rapidly decreasing. It is reasonable that, in the near future, a deeper knowledge of this important financial statement will become widespread even among practitioners. This will inevitably lead to a higher degree of attention by preparers of financial statements in the classification of different kinds of cash inflows and outflows within the three main areas of the report.

Another reason that might contribute to explain the low level of attention paid by the Italian companies included in our sample to the segregation of interest outlays from those arising from "operations", could be linked to the unusual low level of interest rates experienced in this period. If an upsurge in the cost of capital provided by banks and other financial institutions (so-

called "cost of debt") occurs, it will probably induce an increased level of awareness and attention to the topic here described.

As already noted, we did not find a significant correlation between the financial leverage of the firm and the classification choices made by the companies. Perhaps, a relatively unassuming answer to this puzzling observation is that, due to the normal prevalence of borrowed capital over risk capital in the composition of financial structure of Italian companies, it is quite difficult in the Italian business environment to establish a level of leverage that is totally or almost irrelevant in determining the importance of the amounts incurred as interest expenses or paid as interest costs in the period. Moreover, a more material parameter to gauge this phenomenon could be the magnitude of the differential between return on capital employed (ROCE) and the cost of debt (ROD).

All this being said, we can argue that the flexibility offered by IFRS in the classification of cash flows items is too wide. The amplitude of choices left to preparers definitely limits and hinders the comparability of cash flow statements between different firms. In our opinion, the issue is aggravated by the general lack of additional disclosure that surrounds this pivotal statement. It would be extremely useful if the preparers disclosed the classification choice they made, in order to make users of financial information more aware of their impact on the cash flow statement. Our data shows that the magnitude of the effects deriving from the classifications is relevant, and in some cases very relevant, even in an economic context in which exceptionally low rates were registered. Further research is needed to understand the determinants of these managerial discretional choices and to ascertain their effect on the perceptions about the ability of an enterprise to generate new economic value in the future, while maintaining a strong financial position.

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