University of St.Gallen

Institute of Accounting, Control and Auditing

Implementing Recurring and Nonrecurring Disaggregation to Enhance Cash Flow Statement Disclosure

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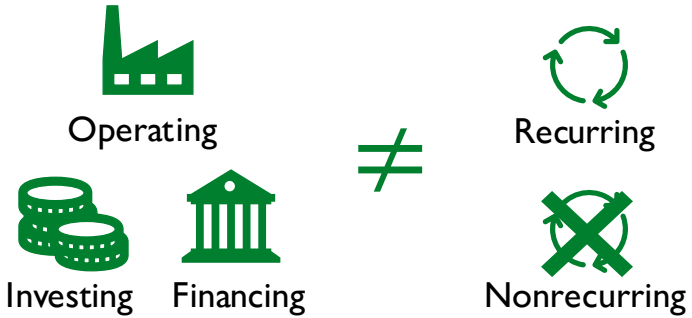
From insight to impact.

Idea & Hypotheses



"*Analysts ask for the recurring cash flows generated by the entity, a data point that cannot be deduced from the Statement of Cash Flows*" (FASB-IASB, 2024, p. 16)

- Financial Statement Presentation Project *(2004–2010)*
- Targeted Improvements to the Statement of Cash Flows *(2023–Present)*
- IFRS 18: Presentation and Disclosure in Financial Statements *(2024)*
- IASB Research Project on the Statement of Cash Flows *(2024–Present)*

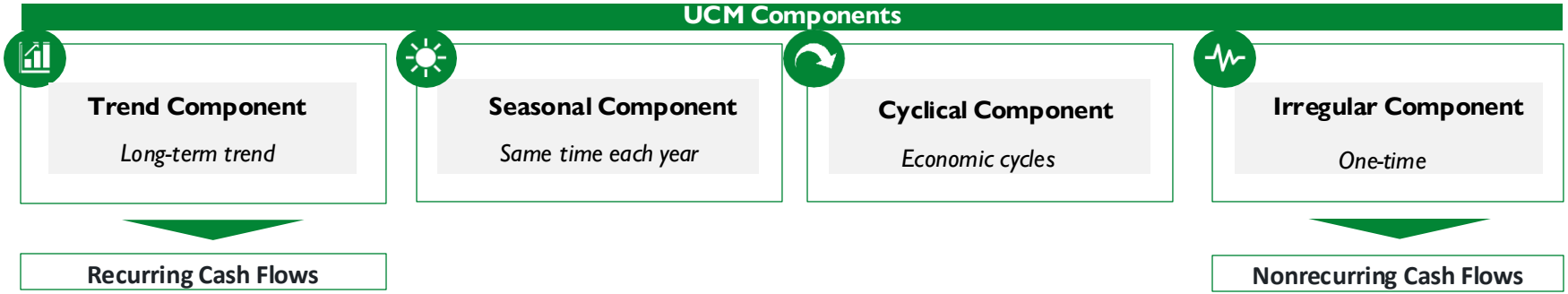
- **H1: Nonrecurring items in OCF correspond to greater analyst cash flow overestimation**
- **H2: Recurring cash flows predict future cash flows better than the activity classification**

(Charitou et al., 2018 ; Gordon et al., 2017; Ryan et al., 2006; Lightstone et al., 2014; Saito & Yasuda, 2023; Rouen et al., 2020; Esplin et al., 2014,;

Data

- **IFRS** & **U.S. GAAP** annual data
- **1993** to **2024**
- **Compustat** and **I/B/E/S**

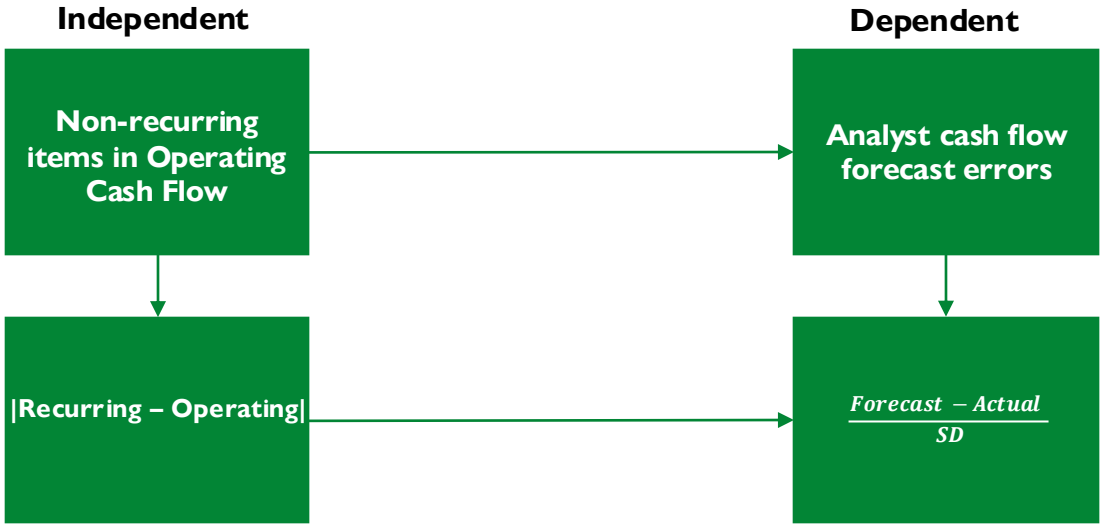
- Unobserved Components Model (UCM) decomposes time series data into underlying components:



(Gardner et al., 2024)

Method

H1



H2

$$\textbf{Total Cash Flow}_{i,t+1} = \beta 0 + \beta 1 \times \textbf{OCF}_{i,t} + \beta 2 \times \textbf{ICF}_{i,t} + \beta 3 \times \textbf{FCF}_{i,t} + \Sigma\beta_{i,t} \times \text{Controls}_{i,t} + u_{i,t}$$

vs

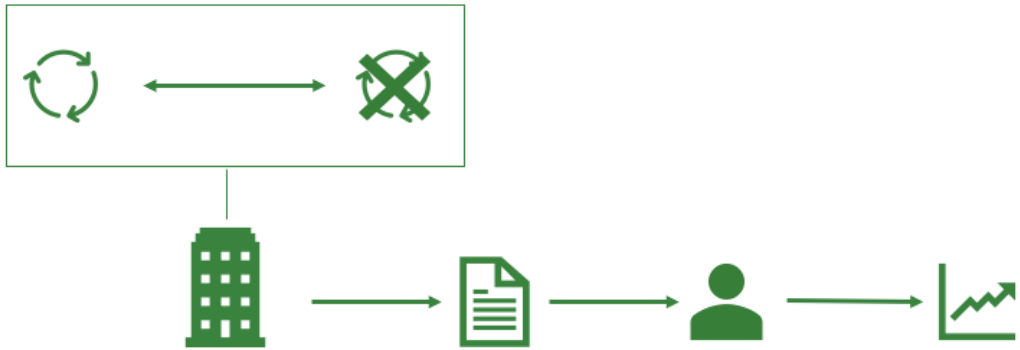
$$\textbf{Total Cash Flow}_{i,t+1} = \beta 0 + \beta 1 \times \textbf{Recurring Cash Flows}_{i,t} + \beta 2 \times \textbf{Nonrecurring Cash Flows}_{i,t} + \Sigma\beta_{i,t} \times \text{Controls}_{i,t} + u_{i,t}$$

Control Variables

- ROA
- Leverage
- Size
- GDP Growth
- Analyst coverage
- Management earnings guidance
- Financial Distress (Z-score)
- Large M&A events

So what?

- We contribute to **information economics** by proposing **disclosure that is useful to decision-makers:**



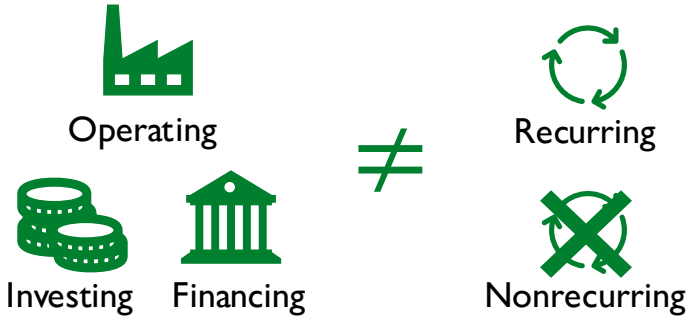
Standard Setter

Recurring + Activity

Analyst/Investor

DCF

Conclusion



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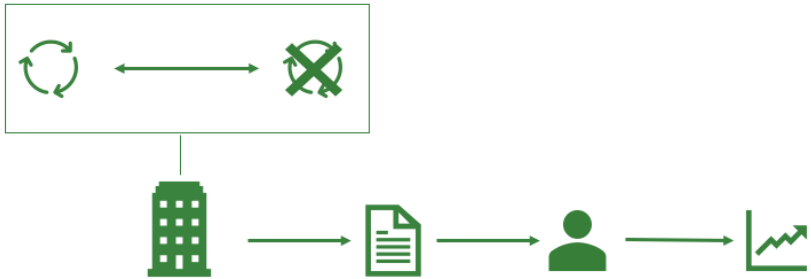

Thank you!

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Questions?
Feedback?


Appendix

One of the original reasonings for O/I/F was forecasting…

"Classification in financial statements facilitates analysis by grouping items with essentially similar characteristics [...] Analysis aimed at ***objectives such as predicting amounts, timing, and uncertainty of future cash flows*** *requires financial information segregated into reasonably homogeneous groups. For example, components of financial statements that consist of items that have similar characteristics in one or more respects, such as* ***continuity or recurrence****, stability, risk, and reliability, are likely to have* ***more predictive value*** *than if their characteristics are dissimilar."* (Financial Accounting Standards Board, 1987, p. 27)

Methods H1

1) Independent Variable:

Recurring-Operating Gap (ROG) captures how much nonrecurring items are part of "operating" activities:

$$\textbf{ROG}_{i,t} = |\text{Recurring Cash Flows}_{i,t} - \text{OCF}_{i,t}|$$

2) Dependent Variable:

Standardized unexpected earnings (SUE) captures the magnitude of earnings surprises; we can adapt this measure to cash flows as such:

$$\textbf{SUCF}_{i,t} = \frac{\text{Analyst Cash Flow Forecasts}_{i,t} - \text{Actual } Cash\ Flows_{i,t}}{SD(Actual\ Cash\ Flows_{i,t})}$$

3) Regression:

$$\textbf{SUCF}_{i,t} = \beta 0 + \beta 1_{i,t} \times \textbf{ROG}_{i,t} + \Sigma\beta_{i,t} * \text{ROG\_lags} + \Sigma\beta_{i,t} * \text{SUCF\_lags} + \Sigma\beta_{i,t} \times \text{Controls}_{i,t} + u_{i,t}$$

4) Interpretation of the coefficient:

- **If β insignificant:** Analysts can correctly identify the recurring component of CF
- **If β > 0 and significant:** Analysts **overestimate** the recurring CF
- **If β < 0 and significant:** Analysts **underestimate** the recurring CF

Methods H2

O/I/F Activity

1) Baseline Variables:

$OCF_{i,t}$; $ICF_{i,t}$; $FCF_{i,t}$

2) Run the regressions:

$$\textbf{Total Cash Flow}_{i,t+1} = \beta 0 + \beta 1 \times \textbf{OCF}_{i,t} + \beta 2 \times \textbf{ICF}_{i,t} + \beta 3 \times \textbf{FCF}_{i,t} + \Sigma \beta_{i,t} \times \text{Controls}_{i,t} + u_{i,t}$$

3) Compare standardized coefficient and R2 with UCM

If $R^2_{Activity} > R^2_{UCM}$, $and\ \beta_{Activity} > \beta_{UCM}$, or β_{UCM} is not statistically significant

 recurring CF disclosure does not improve forecasts of CF over the activity classification

Recurring/Nonrecurring

1) Decompose CFs into recurring and non-recurring with UCM:

Trend Component = Recurring

Irregular Component = Nonrecurring

2) Baseline variables after UCM:

Recurring CF_t

Nonrecurring CF_t

3) Run the regressions:

$$\textbf{Total Cash Flow}_{i,t+1} = \beta 0 + \beta 1 \times \textbf{Recurring Cash Flows}_{i,t} + \beta 2 \times \textbf{Nonrecurring Cash Flows}_{i,t} + \Sigma \beta_{i,t} \times \text{Controls}_{i,t} + u_{i,t}$$

4) Compare standardized coefficient and R2 with no Activity

If $R^2_{UCM} > R^2_{Activity}$, and $\beta_{UCM} > \beta_{Activity}$, and β_{UCM} is statistically significant recurring CF disclosure improves forecasts of CF over the activity classification

Compare the two for H2

An example of decomposition:

Using UCM **for Apple in 2024**, it had **- $794 million** in total cash flows that year.

OCF: $118.254 billion

ICF: $2.935 billion

FCF: -$121.983 billion

UCM Components

Trend Component

Long-term trend

Recurring Cash Flows

$8.352 billion

Irregular Component

Unpredictable

Nonrecurring Cash Flows

-9.146 billion

A proposed structure of statement of cash flows...

Operating Cash Flows

Recurring Operating Cash Flows

- …
- …
- …
- …
- …
- …
- …
- …

Nonrecurring Operating Cash Flows

- …
- …
- …

Investing Cash Flows

Recurring Investing Cash Flows

- …
- …

Nonrecurring Investing Cash Flows

- …
- …

Financing Cash Flows

Recurring Financing Cash Flows

- …
- …

Nonrecurring Financing Cash Flows

- …
- …