Quarterly cash flow reporting – is it useful?

A number of companies have scrapped quarterly financial reports but for some small cap companies there is a continuing requirement to report quarterly cash flows. **GERRY GALLERY**, **NATALIE GALLERY** and **BALJIT SIDHU** explain.

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In contrast to requirements in many overseas jurisdictions, there is no general mandate for companies listed in Australia to produce quarterly financial reports. Instead, Australian regulators have adopted half-year financial reporting supplemented by continuous reporting of price-sensitive information.

One exception is for mining exploration companies which are required to lodge quarterly cash flow and activities reports. More recently, the ASX extended quarterly cash flow reporting to companies classified as commitments test entities (CTEs) in order to address governance issues associated with these higher-risk entities.

Background on ASX Listing Rule 4.7B

Prior to 1 September 1999, entities (other than mining exploration companies) holding more than 50 percent of their tangible assets in cash were generally prohibited from listing on the ASX unless they had binding contracts in place that would reduce the proportion of cash held to less than half.

This 'binding contracts' requirement was inconsistent with the rules for mining exploration companies, and precluded listing of many smaller companies with developing businesses in new technology or other intellectual property assets (ASX 2000). The ASX amended Listing Rule 1.3.2(b) to the less stringent requirement for a company to have commitments to spend at least half of its cash, and other assets that are readily convertible to cash, in a manner consistent with its business objectives.

Companies admitted under the new 'commitments test' on or after 1 September 1999 are required to make additional disclosures in their first two annual reports after admission, indicating whether the cash and readily-convertible-to-cash assets held at admission were spent in a way consistent with the companies' business objectives (ASX Listing Rule 4.10.19).

However, these disclosures in annual reports are not considered adequate in meeting the market's need for information because they are not sufficiently frequent and do not provide information about cash flows (ASX, 2002). To address this shortcoming, the ASX introduced listing rule 4.7B from 31 March 2000 requiring commitments test entities (CTEs) to provide quarterly cash flow reports (in the form specified in Appendix 4C) for the first eight quarters after listing. The rationale for requiring quarterly cash flow reporting by CTEs is based on parallels drawn between such entities and mining exploration entities, which are required to provide quarterly cash flow reports in the form specified in Appendix 5B.

The Rule 4.7B reporting requirements apply to three categories of ASX-listed companies:

(1) paragraph (a) applies to those companies that list under the commitments test provisions;
(2) paragraph (b) applies to those companies that are already listed and because of some event (such as by a major change in business activities) are subject to the commitments test and are required to comply with the CTE provisions 'as if' they are newly listed; and

(3) paragraph (d) applies to non-CTE companies that are required to produce quarterly cash flow reports at the discretion of the ASX. Examples of companies falling into this non-CTE category include: where an entity changes its business activities (but not to the extent that the 'as if' new listing provisions apply); an entity is reinstated after a lengthy suspension; or an entity's cash flow position is critical to its business operations (ASX, 2002).

While the rationale for CTEs to produce quarterly cash flow reports is made obvious by the ASX, reasons for requiring quarterly cash flow reports from non-CTE companies are generally not explicitly stated. The first indication of such a requirement being triggered for a non-CTE company is the filing of the first 4C report. This is a potentially price-sensitive event which has received scant media attention.

Under Rule 4.7B, CTE companies are required to report for a minimum of eight quarters, and non-CTEs must report for an undisclosed period determined by the ASX. Unlike the quarterly cash flow reporting regime for mining exploration companies which allows them to cease such reporting once they become mining producing entities, there is no similar definitive test for CTEs.

"While there is no similar evolutionary process in the case of commitments test entities which would mark a suitable end point for quarterly cash flow reporting, the ASX has determined that four consecutive quarters of positive net operating cash flows is an indication that an entity has reached sufficient maturity for quarterly cash flow reporting no longer to be required." (ASX 2002, para 11)

The ASX reserves the right to review companies on a case-by-case basis, but provides general guidelines on the circumstances in which companies may cease 4C reporting. First, if in the last four quarters of the minimum eight-quarter reporting period the company has reported positive operating cash flows (CFOs), then it is unlikely that the company will be required to continue 4C reporting.

If, however, the 'four consecutive quarters of positive CFOs' threshold is not achieved, then the company will be required to either continue to report until four consecutive quarters of positive operating cash flows have been achieved, or continue to report for another four quarters, after which a further review will be undertaken (ASX, 2002, para 12). Hence, Rule 4.7B provides the ASX with considerable discretion to both initiate and extend quarterly cash flow reporting.

This raises a number of interesting questions with respect to the evolution of this unique quarterly reporting regime. First, what are the characteristics of companies required to report under Rule 4.7B and have these varied since inception in 2000? Second, how successful are CTEs in meeting the threshold set by the ASX to cease quarterly reporting? Third, how useful is the information in the cash flow reports in distinguishing companies that are successful or otherwise?

Characteristics of 4C reporting companies

A search of the Aspect Financial Image Signal Database identified 331 companies that lodged one or more cash flow reports in the Appendix 4C format between 31 March 2000 (the first quarter Rule 4.7B came into effect) and 31 December 2003. Over this period of sixteen reporting quarters, 327 companies lodged a total of 3,291 Appendix 4C quarterly cash flow reports (hereafter referred to as 4C reports). Four of the 331 companies originally identified were lodging only monthly 4C reports (but no quarterly reports), and are therefore excluded from our analysis.

The 327 companies lodging quarterly 4C reports are categorised into the three groups in accordance with Rule 4.7B as: newly listed CTEs (para. (a)); changed to CTEs (para. (b)); and non-CTEs (para. (d)).

We make several assumptions in categorising the companies. First, if the company newly listed on or after 1 September 1999 and the first 4C report was March 2000, we assume the company is a CTE caught by paragraph (a). For companies that listed after March 2000, it is assumed they are also CTEs reporting in accordance with paragraph (a) if they commenced 4C reporting by the next full quarter after listing. Second, if the 'as if new listing' provisions appear to have been triggered by a major event, such as the company changing from mining activities to information technology, and commenced 4C reporting at the same time, it is assumed that the company has changed to a CTE and is reporting in accordance with paragraph (b). Third, where we found no evidence that the commitments test has been applied and the company commenced 4C reporting, we assume the ASX has required the company to report under the provisions of paragraph (d) and the company is not a CTE. Our categorisation of the companies into the three groupings appears appropriate given the limited information available.

As shown in Panel A of Table 1, more than half of the companies (182) commenced 4C reporting during 2000, with the number of new 4C reporters declining to 64 in 2001, 52 in 2002, and just 29 in 2003. Further analysis reveals that of the 327 companies lodging 4C reports during this period, 196 (60%) of the companies were CTEs that commenced 4C reporting at the time of ASX listing; 81 (25%) were already listed and commenced 4C reporting as CTEs under the 'as if newly listed' provisions; and 50 (15%) are non-CTE companies that were required by the ASX to commence 4C reporting.

The decline in the number of CTEs over the four-year period may simply reflect the passing phase of the dotcom boom. Interestingly, while the number of CTE companies commencing 4C reporting significantly declined after 2000, the number of non-CTE companies as a proportion of all 4C-reporters has substantially increased (from 3% in 2000 to 38% in 2003). This suggests that the ASX is increasingly using Rule 4.7B as a monitoring mechanism for companies that are already listed.

Table 1, Panel B presents a breakdown of the companies by industry and the basis on which the companies within each industry group were required to 4C report. Almost two-thirds of the companies are clustered in three

TABLE 1 **FREQUENCIES OF COMPANIES COMMENCING 4C REPORTING BY YEAR AND INDUSTRY**

Panel A: 4C Reporting Commencements by Year

Year	Newly listed CTEs (LR4.7B(a))	Changed to CTEs (LR4.7B(b))	Total CTEs	Non-CTE companies (LR4.7B(d))	Total
2000	131	46	177	5	182
2001	27	24	51	13	64
2002	22	9	31	21	52
2003	16	2	18	11	29
Total	**196**	**81**	**277**	**50**	**327**

Panel B: 4C Reporting Companies by Industry

	Total		**Basis of 4C Reporting**		
	N	Percent	Newly listed CTEs (LR4.7B(a))	Changed to CTEs (LR4.7B(b))	Non-CTE companies (LR4.7B(d))
Energy	1	0.3%	1		
Materials	18	5.5%	8	6	4
Industrials	34	10.4%	19	9	6
Consumer Discretionary	49	15.0%	31	6	12
Consumer Staples	10	3.1%	6	1	3
Health Care	68	20.8%	41	18	9
Financials	30	9.2%	20	8	2
Information Technology	87	26.6%	56	24	7
Telecommunications Services	24	7.3%	9	9	6
Utilities	6	1.8%	5		1
Total	**327**	**100.0%**	**196**	**81**	**50**

industry sectors. In most cases, the 81 companies that changed to CTEs also changed industries; for example, many of the information technology companies were previously mining companies.

How successful are CTEs in meeting the ASX thresholds?

With the initial large surge of CTE companies commencing 4C reporting in 2000, and then the numbers of new CTEs waning over the next three years, it would be expected that if the eight-quarters threshold was being successfully achieved, we would observe a sharp decline in the number of companies 4C reporting by the end of 2003. However, the analysis presented in Table 2 shows that this is not the case. Panel A shows that of the 327 companies that commenced 4C reporting during the four-year period, only 89 (27%) ceased reporting. Of these 89 companies, 38 were 'successful' in that they ceased 4C reporting and continued trading on the ASX; 15 companies changed their activities and/or changed to another form of reporting; and 36 'failed' through delisting or suspension (11 of the 14 suspended companies are under administration).

The industry analysis in Panel B shows that companies in the Information Technology and Telecommunications Services industries have been relatively more successful than those in the Industrials or Customer Staples industries in meeting the ASX thresholds. Additionally, most of the 'changed' companies are in the Materials industry; the majority of these changed to the 5B quarterly reporting format required for mining exploration companies.

Table 2 further shows that the vast majority (73%) of companies that commenced 4C reporting during the four-year period were still reporting at December 2003 and continued to report beyond that time. While 66 companies have not yet reached the eight-quarter minimum threshold, 172 companies reported for eight or more quarters and have continued to report after December 2003. These 172 companies had already reported for an average of 13 quarters to the end of 2003, indicating that they have missed the minimum threshold of eight quarters by a very large margin, and most are clearly struggling to achieve the ASX benchmark, even after their reporting period has been extended by more than five additional quarters.

The ASX's Rule 4.7B generally requires CTEs to achieve positive operating cash flows in the last four consecutive reporting quarters of the minimum eight-quarter reporting period. As shown above, few companies have achieved this threshold and ceased reporting. To assess how successful the 4C reporting companies were in generating positive CFOs, Figure 1 charts the frequencies of companies reporting net positive CFOs, net negative CFOs, or zero net CFOs for each company's reporting quarter. It can be seen that in all 16 reporting quarters net CFOs are negative for the vast majority of companies.

It is evident in Table 2 that the ASX appears to exercise some discretion with respect to the achievement of 'four consecutive quarters of positive CFO' threshold once a company has reported eight or more quarters; perhaps this is done in recognition of the difficulty in achieving the threshold. While almost all of the 38 'successful' companies reported for eight or more quarters, five CTEs achieved a majority of positive CFOs across all reporting quarters, but not consecutively, and were permitted to cease 4C reporting.

Is cash flow information useful?

The stated objective of quarterly cash flow reporting is to assist the market to understand the extent to which an entity is achieving its goals (ASX 2002). Cash flow statements provide valuable information about how a company's initial cash outlays contribute to generating future inflows. To evaluate how the 4C reporters have applied their cash, the median cash flows from operating, investing and financing activities (CFO, CFI and CFF respectively) are charted in Figures 2, 3 and 4 for the three groupings of companies: 'successful', 'failed' and 'continuing to 4C report'.

Figure 2 presents the median cash flows for the 38 successful companies

TABLE 2 **COMPANY SURVIVORSHIP AND DURATION OF 4C REPORTING**

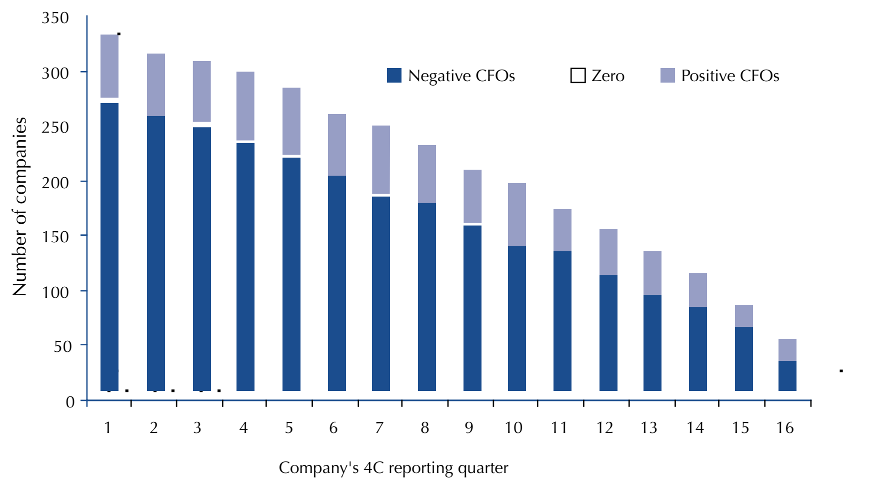
Panel A: Survivorship

CEASED 4C REPORTING	**Total**		**< 8 reports**	**≥ 8 reports**
Still trading (Successful)				
Achieved 4 or more consecutive quarters with positive CFOs	28	8.6%	1	27
Majority of quarters have positive CFOs but not 4 consecutive quarters	8	2.4%	3	5
Cannot determine why 4C reporting ceased	2	0.6%		2
	38	11.6%	4	34
Changed activities and/or changed to another form of reporting (Changed)	15	4.6%	6	9
Ceased trading (Failed)				
Delisted	22	6.7%	21	1
Suspended	14	4.3%	3	11
	36	11.0%	24	12
Total Ceased Reporting	89	27.2%	34	55
CONTINUED 4C REPORTING				
Still trading and continued 4C reporting after 31 December 2003	238	72.8%	66	172
Total	**327**	**100%**	**100**	**227**

Panel B: Industry Analysis of Survivorship

	Total		**Ceased 4C Reporting**			**Continued 4C Reporting**
	N	Percent	Successful	Changed	Failed	
Energy	1	0.3%		1		
Materials	18	5.5%		10	1	7
Industrials	34	10.4%	2		7	25
Consumer Discretionary	49	15.0%	9		9	31
Consumer Staples	10	3.1%			2	8
Health Care	68	20.8%	3		4	61
Financials	30	9.2%	6		4	20
Information Technology	87	26.6%	12	4	7	64
Telecommunications Services	24	7.3%	5		2	17
Utilities	6	1.8%	1			5
Total	**327**	**100.0%**	**38**	**15**	**36**	**238**

FIGURE 1 **SIGN OF CASH FLOWS FROM OPERATING ACTIVITIES (CFOs) BY COMPANY REPORTING QUARTER**



(identified in Table 1) across the 16 reporting quarters. The chart shows that the fifth quarter is the point at which CFOs change from negative to positive for the majority of the successful companies, and remain positive in subsequent quarters. It is also evident that during the first four quarters the operating cash outflows are significantly smaller than the investing outflows, indicating most of the cash outlays were applied to acquire productive assets.

A markedly different picture emerges in Figure 3 for the 36 failed companies. The median CFOs are negative in all quarters (except the last quarter), and are proportionately larger than investing outflows in all except the fifteenth quarter, indicating relatively more cash was spent on day-to-day activities than on investing in assets. The patterns of cash flows in the chart for companies that are still reporting (Figure 4) show trends that are alarmingly very similar to that of the failed companies. That is, median CFOs are negative in all quarters, and in the early quarters, proportionately more cash is applied to pay for operating activities than investments.

This analysis suggests companies that generate positive CFOs after four quarters are likely to be successful, and accordingly the ‘four consecutive CFOs’ threshold appears to be an appropriate indicator. Another distinguishing feature of successful versus unsuccessful is the relative proportion of cash outlays between investing and operating activities. The large proportion of investing cash outlays by the successful companies in their first four quarters appears to have established a base for generating positive CFOs in the fifth and later quarters.

In contrast, the relatively small proportion of cash outlays on investments across all quarters for the continuing 4C reporters perhaps explains the inability of most to achieve positive CFOs, even after eight and twelve quarters.

Conclusion

Our analysis shows that for companies reporting quarterly cash flows in

FIGURE 2 **MEDIAN QUARTERLY CASH FLOWS OF 38 SUCCESSFUL COMPANIES (390 OBSERVATIONS)**

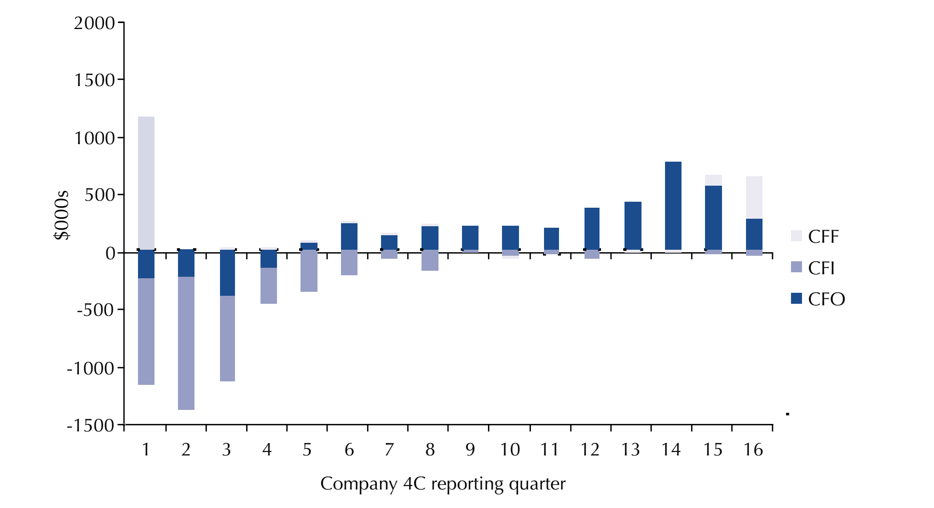


FIGURE 3 **MEDIAN QUARTERLY CASH FLOWS OF 36 FAILED COMPANIES (244 OBSERVATIONS)**

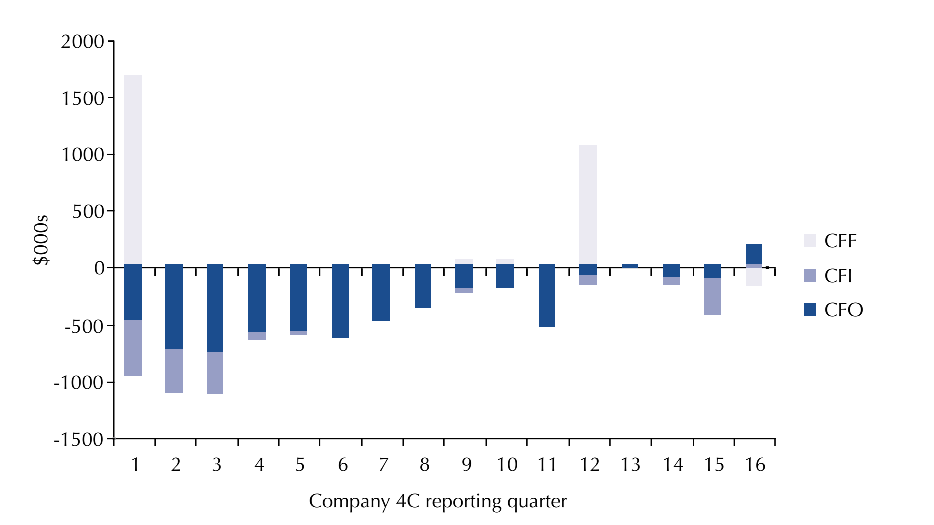
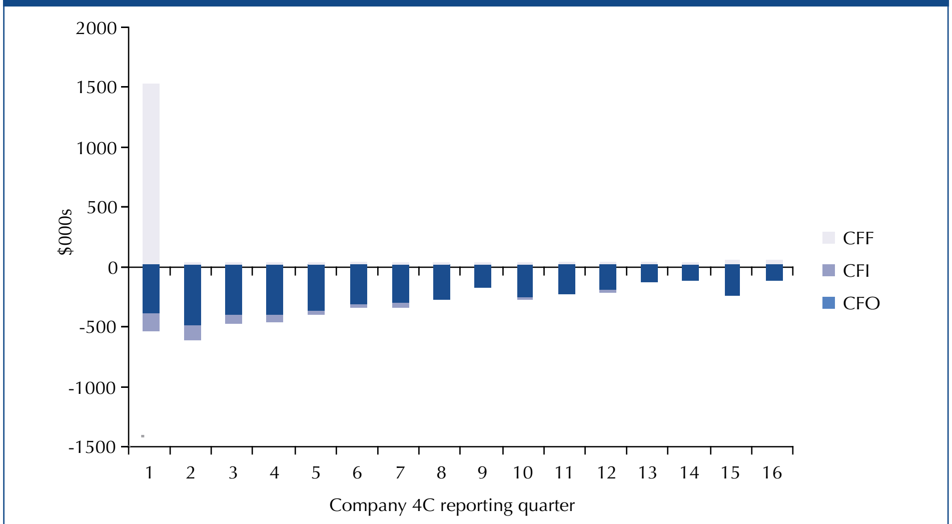


FIGURE 4 **MEDIAN QUARTERLY CASH FLOWS OF 238 COMPANIES CONTINUING TO 4C REPORT (2529 OBSERVATIONS)**



accordance with ASX Listing Rule 4.7B during the four years from 2000, the success rate has been very low. While the vast majority are still reporting and their success or otherwise is yet to become apparent, they are clearly struggling to achieve positive operating cash flows, let alone four consecutive quarters of positive CFOs. Closer monitoring of these higher-risk entities through more frequent structured reporting is therefore clearly warranted.

While the criteria for the commencement and duration of quarterly 5B reporting by mining exploration companies is clear (i.e., they must report for as long as they are exploration companies), the criteria applied to 4C reporting is less clear, particularly for non-CTE companies. It would therefore be helpful to investors if public announcements were made in relation to each of the following potentially price-sensitive events:

(a) The date at which 4C reporting is required to commence, which paragraph of Rule 4.7B (a, b or d) has been applied, and the reason for commencing 4C reporting if the company is a non-CTE;

(b) The date at which the ASX has permitted the company to cease 4C reporting, and the reason for cessation if the company is a CTE and has not met the minimum thresholds (i.e. the ASX has exercised discretion); and

(c) If the ASX reviews a CTE and requires it to continue 4C reporting after it has met the minimum thresholds, the reasons for extending the reporting period and the duration of the extended period.

Such mandatory disclosures supplementing the quarterly cash flow reporting requirements would contribute to further strengthening the enhanced disclosure environment in Australia.

References

Australian Stock Exchange, Exposure Draft: "Proposed Quarterly Reporting for Entities Admitted on the Basis of Commitments", January 2000.

Australian Stock Exchange, Guidance Note 23 "Appendix 4C", March 2002.

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