

PROPOSAL for FASB consideration

April 14, 2020

The concept proposed herein was first published in *The Journal of Accountancy*, April 2012:

***The Missing Piece in Liquidity Calculations – Why calculating the
“current portion of fixed assets” would provide a more accurate picture of financial health***

Proposal: Amend financial reporting standards to include the reporting of the Current Portion of Fixed Assets (CPFA).

Definition & Calculation: The Current Portion of Fixed Assets (CPFA) is the portion of fixed assets scheduled to be depreciated in the current period.

Precedent in GAAP: The basis in GAAP for the Current Portion of Fixed Assets is the same as for depreciation expense. GAAP mandates that the portion of fixed assets used up in the preceding period must be estimated and reported as depreciation expense on the income statement (Matching Principle). How to estimate depreciation expense is often debated, but the need to report depreciation expense is irrefutable, and unrefuted.

Depreciation expense looks backwards in time: the *portion of fixed assets used up in the preceding period*. CPFA looks forward in time: the *portion of fixed assets that will be used up in the coming, current period*. Both are predetermined, both are derived from the depreciation schedules of the fixed assets. Each fixed asset is booked with an estimated life and depreciation schedule. The depreciation scheduled for each and every year of life of the asset is known, including the depreciation scheduled for next year, the current year. The Current Portion of Fixed Assets (CPFA) is the portion of fixed assets scheduled to be depreciated in the current period.

Further GAAP precedent for reporting the Current Portion of Fixed Assets is found on the right side of the balance sheet: long-term liabilities are divided into a current portion—due to be paid in the current year—and a future portion—the portion scheduled to be paid in later years. Applying the same logic to the left side of the balance sheet divides fixed assets into a current portion—the portion scheduled to be depreciated in the current year—and a future portion—to be depreciated in later years.

Technically Feasible Solution / Costs

No Cost, Ease of Reporting There is virtually no cost to calculate or report the Current Portion of Fixed Assets because the number is already in the company’s books, predetermined when the fixed assets were booked. Even today, a CEO could ask the controller, “What is the total depreciation scheduled for next year?” and reasonably expect an answer in short order.

No adverse effects Reporting CPFA on the balance sheet will have no effect on the income statement: It has no effect on revenue, expenses, profit, or taxes. On the balance sheet, reporting CPFA will have no effect on total assets, liabilities, owners’ equity, or financial leverage. Reporting CPFA only divides fixed assets into a current portion and a future portion.

No injured parties No party would be hurt by reporting of CPFA. To the contrary, there are benefits for companies, lenders, investors, as well as for the overall economy. This paper will detail two key benefits.

BENEFIT #1: Correcting Negative Working Capital

Accounting and finance textbooks teach that Working Capital is a measure of liquidity, and *negative working capital* is a sign of illiquidity, a red flag. But experienced analysts do not take this red flag seriously. AT&T and Walmart each reports a *multi-billion dollar negative* working capital every year, yet they pay their creditors on time and enjoy positive credit ratings. This paradox is resolved with the discovery of CPFA—an account missing from the balance sheet.

Accounting convention recognizes that the *portion* of long-term liabilities that is due in the current period be sliced off, named (we will use “Current Portion of Long-term Debt,” CPLTD, although there are variations), and reported as a current liability. The logic is sound. The problem is that the same logic was never applied to the left side of the balance sheet.

Fixed assets are not “fixed.” Fixed assets will be used in normal business activity in the current period, and a portion will be “used-up” in the current period, diminishing the value of the fixed assets by the wear-and-tear from their use. Accounting practice acknowledges this by deducting the portion of fixed assets used up as depreciation expense on the income statement. Looking forward, the portion scheduled to be used up, depreciated, in the next (current) period is also known. Consequently, fixed assets on the balance sheet can be divided into a current portion—to be depreciated in the current year—and a future portion for use in future periods, thus following the precedent of dividing long-term debt into a current portion and future portion.

In short, the formula for working capital is flawed because it includes CPLTD in current liabilities but does not include CPFA in current assets. This imbalance routinely understates working capital, and in extreme cases reports—in error—a *negative* working capital.

AT&T’s Negative Working Capital At FYE 2018, AT&T’s balance sheet reported \$51 billion in Current Assets, and \$64 billion in Current Liabilities. The textbook working capital was a *negative \$13 billion*—a sign of illiquidity.

AT&T is heavily invested in fixed assets—90% of total assets. The *current* portion of fixed assets is therefore a significant amount. When AT&T’s CPFA is reported as a current asset, its working capital becomes positive \$15 billion. (Appendix provides a detailed analysis of AT&T’s liquidity)

No one seriously thinks AT&T is illiquid. Security analysts work around this inconvenient, false indicator. But small businesses are not so fortunate.

Is there a “need” to correct the calculation of Working Capital?

“Good analysts likely keep the inconsistency in mind when evaluating liquidity and would not over rely on the current calculation of working capital.” (university professor)

“...analysts already take such matters into consideration when they review expected cash outflows for capital expenditures from the cash flow statement, depreciation expense, age of assets and other measures, so I am not sure another accounting change would change the outcome of the analysis. (KPMG partner)

The partner is correct, if diplomatic. In fact, security analysts *ignore* negative working capital. AT&T and Walmart have no difficulty attracting credit despite reporting multi-billion dollar negative working capital.

These comments provide the first argument for the need to correct the calculation of working capital: ***If something is so flawed that we work around it or ignore it, and now we have the missing piece to correct it, it would be negligent for GAAP to continue to ignore the problem, and now the solution.***

Damage to SMEs There is a more critical “need.” AT&T gets its credit from capital markets, but small and medium enterprises (SMEs) are dependent on community banks where the definition of working capital is codified in their written credit policies and credit scoring models as primary measures of liquidity. Community bankers cannot work-around or ignore dogma with bank examiners and CPA auditors watching to see if they are following their own policies.

True story: As a community banker I worked with our cash management specialist to structure a sophisticated package to attract a major client from another bank that would bring in millions of dollars in long-term loans. But the cash management package required a small \$150,000 stand-by credit line to cover daylight overdrafts. In principle it would never be drawn, nevertheless, my credit administrator declined it: **“I cannot justify granting more short-term credit to a company that already has a \$1 million negative working capital.”** Correct decision?

The company was heavily invested in fixed assets, financed by long-term loans. CPLTD accounted for a substantial portion of current liabilities making WC appear to be negative. But the company’s investment in fixed assets meant that it also had a large Current Portion of Fixed Assets, which if reported as a CA would have revealed that WC was in fact positive. Like AT&T and Walmart, the company was liquid. Unlike AT&T and Walmart, *negative* working capital precluded it from obtaining even a token amount of short-term credit.

Bank policies cannot change until CPFA is accepted by FASB. Until then, credit will be denied to worthy SME borrowers, banks will miss out on good loans, and the economy will suffer from an unnecessary constraint on credit.

BENEFIT #2: New Tools to Understand LIQUIDITY

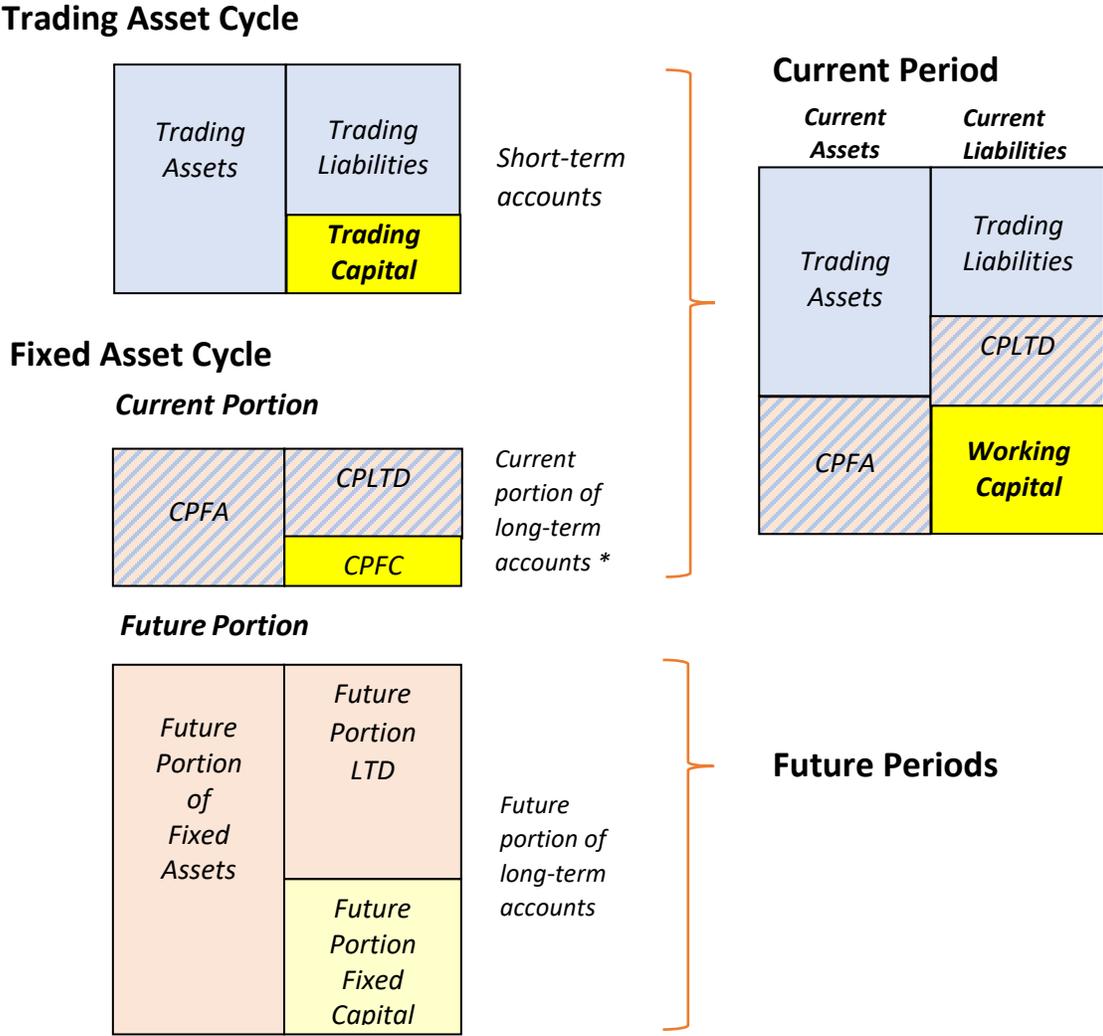
The formula for working capital is imbalanced because it includes the current portion of long-term debt (CPLTD) in current liabilities while excluding the current portion of fixed assets (CPFA) from current assets. The solution discussed above balances the equation by including CPFA in current assets. The alternative solution is to leave CPFA out of current assets, but also remove CPLTD from current liabilities.

CPFA and CLTD are sister accounts that differ from all other accounts on the balance sheet because they stand at the intersection of short-term and long-term: they are current accounts derived from long-term accounts, as is evident from their names: the *current* portion of *fixed* assets, the *current* portion of *long-term* liabilities.

In Figure 1, CPFA and CPLTD are separated from short-life assets and short-maturity liabilities—accounts that turn over *in their entirety* in the current period. This produces a subset of current accounts which

we will call **Trading Assets** and **Trading Liabilities** (blue boxes). The excess of trading assets over trading liabilities produces **Trading Capital**, a new tighter measure of liquidity.

Figure 1
Cash Cycle Balance Sheet
 Two tiers of liquidity:



* **“Current portion of long-term accounts”**

- CPFA - Current Portion of Fixed Assets
- CPLTD - Current Portion of Long-Term Debt
- CPFC - Current Portion of Fixed Capital

Adapted from the book: *Cash Flow 3.0: Advances in Cash Flow Lending based on Sustainable Cycles*

There is much to be gained by removing the influence of the long-term accounts to focus narrowly on short-term trading accounts. Much of the discussion today about “working capital” focuses narrowly on the main trading accounts: accounts receivable, inventory, and accounts payable. These are the accounts we scrutinize when judging how well a company “manages its working capital.” The *Cash Conversion Cycle (CCC)* calculates the turnover of these accounts which helps determine the need for a revolving credit line. These are also the accounts we scrutinize when calculating the capacity for a revolving credit line, often referred to as a “borrowing base.”

Presently, these tools do *not* align well with working capital. A borrowing base calculation (BBC) can indicate strong support for a credit line even when working capital is negative. Taking CPLTD out of the calculation resolves the conflict by producing the concept of Trading Capital. Trading capital, the BBC, and the cash conversion cycle all track closely together because all exclude CPLTD (and CPFA).

Figure 1 is a conceptual representation only. Suggestions on how CPFA can be reported on the balance sheet will be presented later.

The Appendix, “AT&T – The Power of Two Tiers of Liquidity” will illustrate the benefit of identifying the trading cycle as a subset within overall liquidity.

Preserving & Enhancing the Meaning of “CURRENT”

The balance sheet attempted to divide all accounts into either short-term or long-term—current or non-current. This effort failed to recognize that ***fixed assets are also engaged in the current business activity***. Fixed assets are not consumed in their entirety, like trading assets, but a *portion* is, in fact, used up in the current period, just as long-term debt is not due in its entirety in the current period, but a *portion* is due in the current period. Together, CPFA and CPLTD represent the ***“current portion” of “long-term accounts.”***

A company must use trading assets and fixed assets together to generate revenue. The mini-balance sheet on the right-side of Figure 1 (previous page) shows the “Current Period” as a combination of the trading accounts and the current portion of long-term accounts. The defining characteristic of all “current” accounts is that they will be written off the balance sheet—assets expensed, debts paid—in the coming, current period.

Non-current accounts are scheduled to *remain* on the balance sheet at the end of the current period. They are identified in Figure 1 as the *Future Portion of Fixed Assets* and the *Future Portion of Long-Term Debt*. Corrected in this manner, the division of the balance sheet into two sections—current and non-current—is precise and accurate.

The discovery of CPFA preserves and enhances the intended meaning of “current.” “Current” now includes *all* resources consumed and *all* debt due in the current period.

IS CPFA a CURRENT ASSET? -- Re-thinking “Liquidity”

The concept of the Current Portion of Fixed Assets is cogent and entirely consistent with GAAP principles. In the eight years since it was first published in *The Journal of Accountancy*, and subsequently in *The RMA Journal*, no one has challenged the concept itself. Resistance comes when the concept is applied: Is CPFA a current asset?

Challenge #1: A truck is not a liquid asset

A defining characteristic of current assets is that they are “liquid.” We think of inventory as liquid because it can be exchanged for cash. The cash may be delayed as an account receivable, but it is still realized in the current period, so A/R and inventory are both liquid assets. In contrast, a fixed asset such as a truck is not perceived to be liquid because a company does not exchange it for cash.

It is time to re-think what it means for an asset to be liquid. Is inventory more “liquid” than a truck?

Jerry buys and sells product. His primary asset is inventory which he financed with the help of a short-term loan due in the current period. His current assets exceed his current liabilities, so we consider him liquid. But can Jerry take a box of his inventory to the bank to pay his loan? No.

**Liquidity principle #1: Assets do not repay loans. Revenue repays loans.
 Assets must be used in business operations to generate revenue to repay the loans.**

Sam’s Hauling: Sam is in the hauling business. His primary asset is a truck, which he financed with a five-year term loan from his bank. Like Jerry, Sam has a loan payment due in the current period (1/5th of the loan—his CPLTD). Beyond a couple hundred dollars in his pocket, Sam has no inventory and no accounts receivable, virtually no current assets.

Sam’s conventional Balance Sheet			
Current Asset: Cash	\$200	↔	Current Liability: CPLTD (1/5 th of \$20,000 loan)
			\$4,000
Fixed Asset: Truck	\$25,000	↔	Long-term debt (4/5ths of \$20,000 loan)
			\$16,000
			Owners’ Capital
			\$5,200
Total Assets	\$25,200		Total Liabilities + Equity
			\$25,200

By conventional reporting, Sam is illiquid: his current assets are not sufficient to cover his current liabilities. His working capital is a *negative* \$3,800 (=CA \$200 – CL \$4,000). But is he really *illiquid*? Is he destined to default? Of course not. Sam will use his truck, a **fixed** asset, to generate revenue to repay the loan.

The formula for working capital is flawed in concept because it suggests that all current liabilities, including the CPLTD, must be covered by “current assets.” Sam’s case proves this to be wrong. The revenue (cash) that Sam generates by using his truck does not go through “current assets.”

Liquidity principle #2: Revenue does not have to go through “current assets” (as presently defined).

Sam’s truck does not appear to be liquid because he does not *exchange* the truck for cash (revenue). But when Sam agrees to a transaction with a client, he is agreeing to *exchange some* of the value of his fixed asset for cash: the wear-and-tear on the truck that will reduce its value as an asset.

In the following balance sheet, Sam’s fixed asset is divided into a current portion and a future portion, matched to the current portion and future portion of the loan on the right side.

Sam's Symmetrical Balance Sheet with CPFA				
Trading Asset: Cash	\$200	↔	Trading Liabilities	\$0
Current Portion of Fixed Asset (1/5 th of \$25,000)	\$5,000	↔	Current Portion of Long-term Debt (1/5 th of \$20,000)	\$4,000
Future portion of Fixed Asset: Truck (4/5ths of \$25,000)	\$20,000	↔	Future portion Long-term debt (4/5ths of \$20,000)	\$16,000
			Owners' Capital	\$5,200
Total Assets	\$25,200		Total Liabilities + Equity	\$25,200

Notice the symmetry: CPFA, equal to one-fifth of the asset, aligns with CPLTD, equal to one-fifth of the loan. The logic is compelling: **Sam will use up one-fifth of the life of his truck to generate revenue to repay one-fifth of his loan, without going through A/R or inventory.** Both CPFA and CPLTD will be written off the balance sheet by year-end—that is, both are “current.” At the end of the current period, 4/5ths of the asset and 4/5ths of the loan will remain on the balance sheet for use in future periods.

If Sam wants to expand his business to include inventory (packing boxes and supplies) or accounts receivable (corporate accounts) and applies to his bank for a short term credit, his banker might just say: “I can’t justify granting short-term credit to a business that already has a negative working capital!” Under conventional reporting, Sam reports a *negative* working capital, but when CPFA is matched to CPLTD—both counted as current—Sam’s working capital is a positive \$1,200 (= CA \$5,200 – CL \$4,000).

**Challenge #2: But revenue from the truck is dependent on the truck being used. (entrepreneur)
There is no guarantee that the truck will generate cash. (university professor)**

Absolutely true. Sam *must* use the truck to generate revenue (Liquidity principle #1). But that is equally true for Sam’s friend Jerry. Jerry must sell his inventory to generate revenue, and there is no guarantee that he will. Sam is just as likely to find a customer (to pay him to haul something) as Jerry is to find a customer (to buy his products). *Either entrepreneur can generate cash (revenue) in the near term, regardless of the fact that one is using a fixed asset while the other is using a trading asset.*

GAAP Definition of “current assets”

Current Assets is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. (Codification 210-10-20 Balance Sheet glossary)

GAAP excludes “depreciable assets” from current assets (210.10.45.1f). That was the reasonable answer to the question FASB faced at the time: “Are fixed assets current or long-term?” But that was an impossible “Have-you-stopped-beating-your-wife” type of question.

The new question for FASB to consider is: Is the **Current Portion** of Fixed Assets a current asset?

The *Current Portion* of Fixed Assets is already consistent with today’s GAAP definition of current assets. As explained in this paper, when fixed assets are used to generate revenue, they are effectively “realized in cash” over multiple years, with a *portion* realized in the current year.

The definition could be improved to expressly acknowledge this:

Current Assets is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed, **in their entirety or the portion thereof**, during the normal operating cycle of the business.

Challenge #3: “The subjective calculation of depreciation (method, useful life, salvage value) is not as reliable as the objective contractual payments due in the next year on debt so the FASB would not prefer your approach.” (KPMG partner)

This challenge suggests that since depreciation is unreliable, we should not use it. By that logic, we should stop deducting depreciation expense from the income statement.

Despite its subjectivity, depreciation expense is an essential GAAP concept. The Matching Principle demands that we match revenue with all expenses used to generate that revenue, including an estimate of how much fixed assets depreciated in value from their use in generating that revenue. The fact that the quantity is difficult to pin down does not mean the quantity does not exist or can be ignored.

The Current Portion of Fixed Assets, *next year’s* scheduled depreciation expense, inherits the same warts as *last period’s* depreciation expense. CPFA is precisely as exact or inexact as depreciation expense given that both are derived from the same depreciation schedules.

AT&T’s depreciation expense may be debatable, but if we did not report it on the income statement, profit would be significantly over-stated. Similarly, if we (continue to) exclude CPFA from current assets, current assets will (continue to be) as significantly understated. In AT&T’s case, working capital will continue to be mis-reported as negative.

Incidentally, inventory valuation—LIFO, FIFO, Ave cost, etc.—has an element of subjectivity too. FASB must always wrestle with subjectivity, not ignore it.

GAAP Definition of Working Capital

Working Capital (also called net working capital) is represented by the excess of the current assets over current liabilities and identifies the relatively liquid portion of total entity capital that constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the entity. (210.10.20 Balance Sheet glossary)

The GAAP definition of working capital will remain unchanged by the reporting of CPFA. Adjusting the definition of current assets to include CPFA automatically adjusts working capital.

In fact, the GAAP definition of working capital endorses the concept of CPFA. Especially noteworthy in the above definition is the second part: “...the relatively **liquid portion** of total entity capital that constitutes a **margin or buffer** for meeting obligations within the ordinary operating cycle of the entity.”

Entity capital is invested in assets, some current, some fixed. We all agree that the portion of entity capital invested in current assets is **working capital**. The portion of entity capital invested in fixed assets could be called **fixed capital**. Further dividing fixed assets into a current portion and a future portion suggests that fixed capital also has a current portion and a future portion.

This is illustrated in Figure 1, the mini-balance sheet on the left labeled “Current Portion of Fixed Asset Cycle.” CPFA and CPTLD are complementary, but not equal. Fixed assets are financed by a combination of debt and entity capital. So too, the *current portion* of fixed assets is financed by a combination of debt—the *current* portion of long-term debt—and entity capital—the *Current* Portion of Fixed Capital, CPFC. Sam’s truck serves as a simple example:

Sam financed his truck with a combination of cash (equity) and a loan (debt). Each year, he will use 1/5th of this truck (\$5,000) to generate revenue to repay 1/5th of his loan (\$4,000). The \$1,000 difference is 1/5th of his cash down payment. Sam recovers a *portion* of the cash he invested—his “entity capital”—each year over the life of the asset. In the current year Sam will recover the *current portion* of fixed capital, CPFC.

	Total	Annually for 5 years
Truck	\$25,000	\$5,000 = CPFA = depreciation
Loan	\$20,000	\$4,000 = CPLTD to lender
Owners’ Capital (cash down)	\$ 5,000	\$1,000 = CPFC to company

The Current Portion of Fixed Capital fits within the GAAP definition of working capital because it is a buffer for the payment of a current liability (CPLTD). Banks require cash-equity down payments precisely to provide this buffer. If the bank granted 100% financing with no down payment—no entity capital—there would be no buffer. A 50% down payment would provide a greater buffer.

Moreover, the GAAP definition of working capital includes a very practical and quantified definition: “working” capital is capital that is “in play,” that is, the capital that will “turn over” because it is invested in assets which will be “realized in cash” in the current period. The GAAP definition refers to this as **liquid capital**. This is the capital that must be redeployed: capital invested in trading assets (trading capital) *plus* the capital invested in fixed assets that is recovered in the current period (CPFC). This is illustrated in figure 1 on the right side:

$$\text{Working Capital} = \text{Trading Capital} + \text{the Current Portion of Fixed Capital}$$

Challenge #4: Does Goodwill have a current portion?

Our discomfort begins with the question: Should Goodwill and other intangibles be on the balance sheet in the first place, and if so, how should they be valued? FASB is currently reviewing this touchy topic. Accounting convention says goodwill is an asset because it represents a value that will contribute to revenue. Following that logic, it will have a current portion and a future portion: the “current portion of goodwill” will contribute to revenue in current period, and the future portion of goodwill will contribute to future periods. That said, the value given by analysts, investors, and lenders varies in the extreme.

At one extreme, community bankers generally give intangible assets no value. Total intangibles is routinely deducted from total assets and from owners’ capital to calculate “*tangible* net worth” and financial leverage. Consistent with this practice, if total intangibles is deducted from owners’ capital, then the *current portion* of intangibles would be deducted from working capital.

At the opposite end is AT&T which has more invested in Goodwill, licenses, trademarks and other intangible assets than it does in Property, Plant and Equipment. If AT&T’s total intangibles were deducted from its owners’ capital, owner’s capital would be negative. Similarly, if the *current portion* of

intangibles is excluded from current assets, working capital would again be negative. The value in AT&T is in its intangibles. In contrast, community bankers lending to closely-held small and medium enterprises prefer tangible assets, not only as the source of cash flow but also as the secondary source of repayment—collateral.

Treatment of intangibles will vary among users of financial statements, but as long as intangibles are amortized, there will be a portion due to be amortized in the current period—the *current portion* of intangibles. Therefore, it would be helpful to distinguish between the “current portion of **depreciable** assets” (tangible fixed assets) and the “current portion of **amortizing** assets,” (intangibles) perhaps in a footnote.

REPORTING CPFA on the BALANCE SHEET

Working Capital – preserved and enhanced Reporting CPFA among current assets is straightforward because it preserves the original design of the balance sheet, dividing it into two parts: current and non-current. CPFA would be reported among current assets in the same manner as CPLTD is reported among current liabilities.

Current Portion Fixed Assets (CPFA)

Current Portion of LTD (CPLTD)

On both sides of the balance sheet, the residuals are *non-current*, that which is scheduled to remain on the balance sheet at the end of the period.

Future Portion Fixed Assets (FPFA)

Future Portion of LTD (FPLTD)

The expression “future portion” is a natural complement to “current portion” and would add clarity to both sides of the balance sheet. On today’s balance sheet total long-term debt is divided into the Current Portion of Long-Term Debt and “Long-term debt.” “Long term debt” is ambiguous, easily misread as “*total* long term debt” when in fact it is only the *future* portion of long-term debt. Fixed assets are net of accumulated depreciation, before being divided into current and future portions.

Trading Accounts The alternative is to take CPLTD out of current liabilities to highlight the accounts involved in the trading cycle—short-life assets and short-maturity liabilities. Instead of Current Assets and Current Liabilities, the upper section would subtotal to **Trading Assets** and **Trading Liabilities**. The lower section would report *total* fixed assets and long term liabilities, but can also identify the current and future portions so that a user can easily add them to trading accounts to get current accounts.

net Fixed Assets

Long-term liabilities

Current Portion (CPFA)

Current Portion of LTD (CPLTD)

Future Portion (FPFA)

Future Portion of LTD (FPLTD)

The advantage of the first approach is that CPFA is the only new term, whereas the second approach introduces the Trading Assets and Trading Liabilities which would require additional definitions in GAAP. To analysts, it does not matter. Simply reporting CPFA provides the information needed to calculate both trading capital and working capital. To this end, even reporting CPFA in a footnote would provide useful information, but would fail to correct the unbalanced balance sheet.

Executive Summary

Precedent:

- GAAP mandates that the portion of fixed assets used up in the current period to generate revenue be deducted from revenue as depreciation expense. CPFA applies the same logic looking forward to identify the depreciation expense scheduled for the next period.
- GAAP mandates that the portion of long-term debt due in the current period be sliced off of long-term debt and reported as current. CPFA applies the same logic to the left side of the balance sheet, dividing fixed assets into a current portion and future portion.

Technically Feasible Solutions & Cost

- Reporting CPFA is virtually cost-free because it is virtually labor free. There is no need for special calculations because CPFA draws on the same data source—depreciation schedules of fixed assets—used to calculate depreciation expense. *CPFA simply gives a (logical) name to a number already in every company's books.*
- Auditing firms can relax—any question of ambiguity was resolved when the fixed assets were booked with their depreciation schedules.
- Reporting CPFA has no effect on income statement accounts—no effect on revenue, expenses, profit, or taxes. CPFA has no effect on total assets or total owners' capital.
- Reporting CPFA has no adverse effect on any party.

Benefits

- CPFA resolves the paradox of negative working capital, removing a false negative indicator that has inappropriately restricted credit. This is a benefit to the economy overall and especially to small and medium enterprises, and all companies heavily invested in fixed assets.
- CPFA brings new insight in understanding liquidity to all users of financial statements.
 - *CPFA brings to light the fact that fixed assets play an integral part in current business activity, working together with trading assets to generate of revenue to repay current debt.*
 - *CPFA preserves and enhances the meaning of current assets and working capital:*
 - **Current assets** in principle are *all assets due to be expensed* in the current period, including all short-term assets (trading assets) and the *current portion* of long-term assets.
 - **Working capital** is the entity capital invested in assets that will turn over in the current period, capital ready to be redeployed—including the capital invested in fixed assets recovered in the period.
 - Removing both CPFA & CPLTD reveals a sub-tier of liquidity, **Trading Capital**, which aligns with other tools used today to analyze the trading cycle, such as the Cash Conversion Cycle.
- CPFA fulfills the accounting principle of *consistency* in reporting by providing the counterbalance to CPLTD to bring symmetry to the balance sheet.

Bottom Line: Reporting CPFA will benefit those who choose to use it, while imposing no cost or burden on anyone who chooses to ignore it.

Appendix: AT&T - The power of Two-tiers of Liquidity

By traditional measure, AT&T is seriously illiquid. Current assets of \$51 billion are not sufficient to cover (repay) current liabilities of \$64 billion. By this measure, the resulting \$13 billion *negative* working capital is a sign of illiquidity and possible default. However, the formula understates working capital by including the Current Portion of Long-Term Debt without including the complementary Current Portion of Fixed Assets.

There are two solutions: Either include *both* CPFA and CPLTD in the formula to produce a correct measure of working capital, or exclude both to produce a new sub-tier of liquidity, trading capital.

To arrive at a correct figure for working capital, CPFA must be counted among current assets. CPFA is not presently reported, so for now we need a reasonable surrogate. CPFA is the depreciation scheduled for *next* year. Depreciation expense does not vary significantly from year to year, so in lieu of CPFA we can use the depreciation expense from *last* year, taken from the Income Statement--\$28 billion. Including CPFA of \$28 billion in current assets brings the new total to \$80 billion which now covers the \$64 billion current liabilities leaving a *positive* working capital of \$15.4 billion.

The alternative is to leave both CPFA and CPLTD out of the calculation to focus on the sub-tier of liquidity: trading capital. AT&T's old "current assets" are the new "trading assets" because they already exclude CPFA. To balance the equation, removing CPLTD from current liabilities produces the new "trading liabilities."

Trading assets	\$ 51.4 billion	= old current assets
Trading liabilities	\$ 57.2 billion	= old current liabilities less CPLTD
Trading capital	< \$ 5.8 billion >	
Trading ratio	=	0.9

Although AT&T's true working capital is positive, its *trading capital* is *negative!* Is that the new red flag of illiquidity?

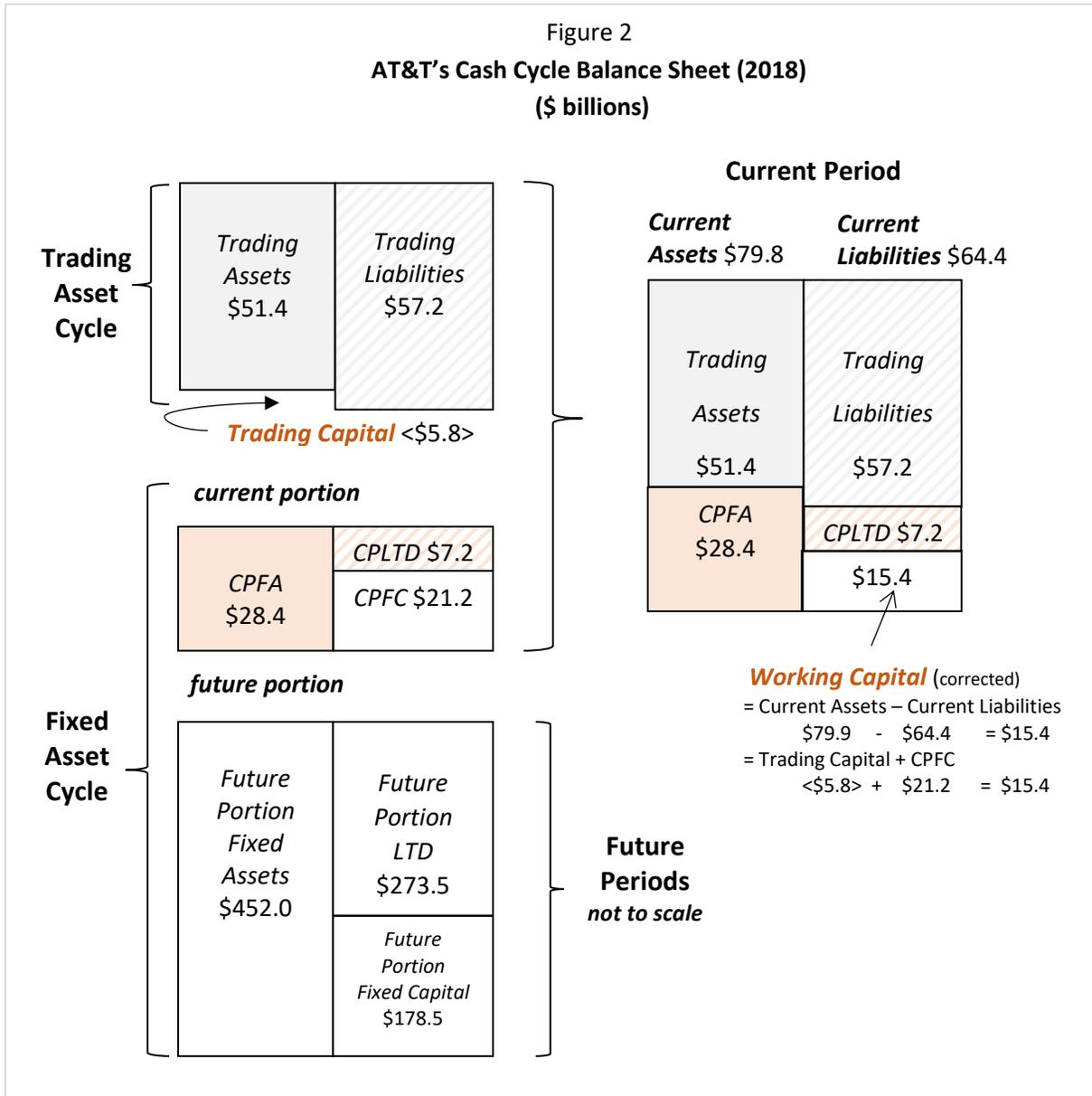
Tolerant Creditors As long as short-term creditors are comfortable rolling over the short-term debt, there is no net reduction in trading liabilities, no "net use of cash." Debt replaces debt. As long as trading liabilities continue to roll over, trading capital can continue to be negative.

The risk of negative trading capital is that the short-term creditors could at some point stop rolling the trading debt and require faster repayment, which would force a use of cash, drawn from insufficient trading assets.

Cross-Cycle Financing...and Refinancing AT&T and other companies with a negative trading capital are essentially *cross-cycle financing* – financing fixed assets with trading liabilities (in excess of trading assets). Cross cycle financing is not uncommon and not necessarily unwise. Short-term credit is often cheaper than long-term credit. Short-term credit facilities that continually roll over are, in effect, long-term financing with "put" options. (AT&T negotiates multi-year revolvers.)

AT&T could change its debt structure to "re-balance" its balance sheet in terms of *duration*—matching the maturities of its liabilities to the maturities of its assets. It could issue a new long-term bond specifically for the purpose of paying down short-term debt, which would move some of the debt from the trading cycle to the long-term cycle. Trading capital would then be positive.

There is a catch: refinancing may not be possible. If fixed assets are highly leveraged with long-term debt, there may not be enough asset or cash flow support for a new bond issue. If both cycles are heavily leveraged, the company's overall financial leverage (total liabilities to total owners' equity) would be high. This is not the case with AT&T.



Cross-cycle repayment AT&T trading cycle is tight, indeed it's negative. But its fixed asset cycle is exceptionally strong. AT&T is heavily invested in fixed assets with a relatively low level of long-term debt financing. As show in Figure 2 (See Fixed Asset Cycle - current portion), the *current portion* of fixed assets exceeds the *current portion* of long-term debt by a substantial margin. CPFA \$28.4 less CPLTD \$7.2 = \$21.2 CPFC.

Recall the lesson from Sam's Hauling: the truck, a fixed asset, is used to contribute directly to cash revenue without going through inventory or accounts receivable. Similarly, AT&T's fixed assets contribute a strong cash flow to its revenue that exceeds what is needed to repay the corresponding CPLTD *four times over* (CPFA divide by CPLTD). The excess can be used to cover the deficiency in the trading cycle—call it cross-cycle repayment. This is precisely what the corrected working capital tells us:

Conclusion: AT&T's working capital vs trading capital As shown in Figure 2 (see Current Period on the right), AT&T's current assets—the total of *all* assets scheduled to be consumed in the current period, including trading assets in their entirety and fixed assets in part, exceeds *all* liabilities due in the current period, including all trading liabilities plus the current portion of long-term debt. *AT&T's trading capital is negative, but its overall liquidity remains positive.*

This still merits a yellow flag because if something precipitates a tightening of short-term credit it is likely to tighten the availability of long-term credit as well, or at least make it more expensive. If refinancing options become scarce or expensive, for the near-term AT&T can live off the strong cash flow from fixed assets to cross-cycle pay its trading liabilities—that's what the positive working capital tells us. But in the long run that is not sustainable because the cash flow from fixed assets is needed to replace fixed assets—hence the yellow flag.

The red flag is for companies that have leveraged both trading and fixed assets, which makes for an inflexible debt burden.

This detailed two-tier analysis of liquidity is made possible by the discovery of CPFA.

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www.sme-lending.com website includes links to several earlier materials:

The Journal of Accountancy *The Missing Piece in Liquidity Calculations – Why calculating the “current portion of fixed assets” would provide a more accurate picture of financial health* April 2012

The RMA Journal *Negative Working Capital is Not Negative – Heresy or Revelation? How the calculation of the “current portion of fixed assets” corrects the miscalculation of working capital* December 2015

The RMA Journal *Trading Capital vs. Working Capital: Two Tiers of Liquidity* October 2017

Book: Cash Flow 3.0 -- Advances in cash flow lending based on sustainable cycles © 2013

YouTube: Negative Working Capital is not Negative