

The Messy Art Of Cash Flow Statements

By Tammy Whitehouse

Cash flow—how a company gets, spends, and invests its cash—has traditionally seemed a fairly straightforward concept in financial reporting. But in the Sarbanes-Oxley era, where even bedrock principles have become subject to new debate, the cash flow statement is getting increasing scrutiny.

Governed by the 66-page body of rules and examples in Financial Accounting Standard No. 95, *Statement of Cash Flows*, disclosures related to cash flow weren't even required by the Securities and Exchange Commission until the early 1960s, says Charles DiLullo, associate accounting professor at American College.

When FAS 95 came into play in 1987 to replace the original "statement of changes in financial position" meant to display cash flow, it was a standard based on principles, not prescriptive rules; companies had some flexibility in how they would arrive at their cash flow figures, DiLullo says. Today's cash flow statement is intended to give investors a view of how a company receives and manages its cash. As DiLullo describes it: "It's a snapshot of where the money came from and how management made its decisions."

The picture can look different, however, depending largely on how carefully companies classify their cash flows, says Charles Mulford, director of the Georgia Tech Financial Analysis Lab and a devotee of the cash flow statement.

Companies tend to get it right when reporting cash balances because those are easily confirmed, he explains. Rather, "it is the classification of that change in cash—the operating, investing, and financing classification—that leads to SEC issue letters," he says.

Indeed, the SEC has shown heightened interest in cash flow classifications in recent years. An SEC staff speech in late 2004 noted concerns over cash flows related to long-term customer receivables, such as how an entity classifies cash flow when it sells merchandise under long-term financ-

ing arrangements through a financing subsidiary.

That distinction tripped up entities like General Motors, Ford, Boeing, and others that sell big-ticket merchandise under long-term financing, Mulford says. While companies often classified cash flows related to such transactions under investing activities, "it should be reported in operating cash flow."

The following year separate staff speeches focused on concerns related to discontinued operations, dealer-floor plan financing arrangements, insurance claim proceeds, loans held for sale, and beneficial interests in securitized loans.

In each case, proper classification was key, Mulford says. "When the SEC comments on the cash flow statement, the issues raised typically focus on classification," he says.

The capital markets have turned over a number of stones in recent years to find cash flow classification problems. Blockbuster, for example, raises eyebrows at the SEC when it classified amounts paid to make additions to its video library as investing cash flows rather than operating cash flows, Mulford says. Microsoft also drew attention when it switched its classification of tax benefits related to non-qualified stock options from financing to operating activities.

Following the SEC's remarks about discontinued operations, questions and concerns rose to such a level that the SEC eventually mapped out a method last year for companies to correct cash flow presentation related to discontinued operations without restating. The Commission issued a notice through the American Institute of Certified Public Accountants offering more precise instruction on how discontinued operations should not be lumped into a single category but properly classified among the three separate categories—operating, investing, and financing—of the cash flow statement.

Challenges Of A Principles-Based Standard

In the wave of restatements that deluged the capital markets in 2005 and 2006, issues related to cash flow were the focus about 11 percent of the time, says Richard Angell, a director of accounting, tax, and advisory services at CBIZ. Within those

cash flow problems, classification of discontinued operations and marketable securities have cropped up most frequently, he says.

As Angell sees it, the number of comments and restatements is evidence, of the challenges in operating under principles-based accounting rules. "One of the issues that comes into play is that there are few rules on the application of the cash flow statement," he says. "It's a more principles-based standard, requiring more judgment. When you see people are not following the guidance, it gives a view of how people apply principles."

Brian Markley, managing director for CFO services firm SolomonEdwards Group, says some preparers have felt too much freedom to report cash flows on a net basis rather than a gross basis—meaning they report only the final effect of a transaction rather than all the incremental cash flows within it. That bad habit has led to some of the cash flow classification problems that have surfaced in recent years. FAS 95 requires cash flow to be reported on a gross basis, not a net basis, he notes.

Jay Hanson, national director of accounting for accounting firm McGladrey & Pullen, says one root cause of problems with the cash flow statement is not efforts to game to results, but simply time.

"It's typically the last thing done," he explains. "Often, not knowing where to put something means it gets plugged in where it doesn't belong. And it hasn't been a big focus for auditors because it's a byproduct of the other financial statements. It's a hybrid of the balance sheet and income statement, so misclassification is seen as something that doesn't make much difference."

Hanson says the SEC is acting to shore up classification problems because they do indeed matter to investors. "Cash flow from operating activities is a critical measure of how a company generates cash from operations and how it uses cash for capital expenditures and other investing activities," he explains. "If the critical measures are wrong, it gives investors a misleading picture of how the company did."

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Mulford