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PERSPECTIVES ON THE CASH FLOW STATEMENT UNDER FASB STATEMENT NO. 95

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PERSPECTIVES ON THE CASH FLOW STATEMENT UNDER FASB STATEMENT NO. 95

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October 2006

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Overview

This paper demonstrates that current cash flow statement classification rules under Statement No. 95, *Statement of Cash Flows* (SFAS-95, 1987), are simplistic and wrought with internal contradictions. As a result, net cash flow from operating activities (NCFO) is often contaminated by the cash flow effects of certain investing and financing transactions, including the income tax effects of those transactions; and a similar contamination often results in net cash flow from investing activities (NCFI), and net cash flow from financing activities (NCFF). It also demonstrates a priori that reporting gross operating inflows and outflows under the direct method with a supplemental reconciliation of net income and NCFO is more informative than reporting NCFO under the indirect method.

A three-part solution to these problems is proposed. First, SFAS-95 should be amended to prescribe the direct method together with a supplemental reconciliation of net income and NCFO. To apply the direct method, accounting systems should be modified to routinely record gross operating inflows and outflows in nominal cash accounts; the patchwork after-the-fact analysis of deriving gross inflows and outflows indirectly is too complicated and prone to error.

Second, the SFAS-95 classification rules should be amended to distinguish where necessary between non-financial and financial companies, and to conform to the underlying economics of the business. In particular, for non-financial companies, SFAS-95 should be amended to classify all interest payments as financing outflows, because they arise from borrowing, a financing activity; and to classify purchases and sales of most short-term non-trading debt securities as financing flows, together with interest collections thereon, because they arise from parking excess cash balances, the opposite of borrowing, another financing activity. For financial companies, SFAS-95 should be amended to classify cash flows from taking deposits and honoring withdrawals as investing flows, because they are the opposite of making and collecting loans, another investing activity; and to classify all interest payments on bonded debt as financing outflows. Other ambiguous and/or inconsistent classification rules under SFAS-95 should also be amended or eliminated. Free cash flow (FCF) should also be defined unambiguously for non-financial and financial companies.

Third, income taxes should be allocated among operating, investing, and financing activities so that (1) actual NCFO is uncontaminated by the income tax effects of investing and financing activities; actual FCF (if reported) is uncontaminated by the income tax effects of financing activities; and (3) actual NCFO, NCFI, and NCFF subtotals are reported on an after-tax basis. Additionally, the income tax effects of individual investing and financing transactions should be disclosed, whether of the current, past, or future period, so that users can more accurately estimate prospective after-tax NCFO (and after-tax FCF) for analytical purposes.

Finally, report users should remember that, except for certain income tax flows, the cash flow statement is a historical report of actual cash flows. For analytical purposes, especially for valuation purposes, the cash flow statement should be adjusted to a prospective basis; it should be adjusted to exclude cash flows that are not representative of past performance and/or not expected to recur in the future, and to include cash flows that are expected to occur in the future that did not occur in the past.

I. Introduction

In the United States, Financial Accounting Standards Board (FASB) Statement No. 95, *Statement of Cash Flows* (SFAS-95, 1987) and Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (SFAS 117, 1993) require most business and not-for-profit enterprises to provide a cash flow statement for each period for which results of operations are provided. The cash flow statement explains the change during the period in cash and cash equivalents, and classifies cash inflows and outflows as relating to operating, investing, or financing activities.[1] Net cash flow subtotals are reported for each category: net cash flow from operating activities (NCFO), net cash flow from investing activities (NCFI), and net cash flow from financing activities (NCFF).[2] Similar requirements are applicable to enterprises following International Accounting Standards Board (IASB) Standard No. 7, *Cash Flow Statements* (IASB-7, 1992), as well as proprietary and nonexpendable trust funds and governmental entities that use proprietary fund accounting under the Government Accounting Standards Board (GASB) Statement No. 9 (GASB-9 1989, ¶ 5-15) in the U.S.

Since the issuance of SFAS-95 in 1987, several limitations and defects of SFAS-95 have been identified that warrant its reconsideration.[3] This paper demonstrates that current FASB cash flow statement classification rules are simplistic and wrought with internal contradictions. As a result, the reported NCFO subtotal is often contaminated by the cash flow effects of certain investing and financing transactions, including the income tax effects of those transactions; and a similar contamination often results in the NCFI and NCFF subtotals. It also demonstrates a priori that

[1] SFAS-95 (1987, fn. 10) permits but does not require separate disclosure of cash flows pertaining to discontinued operations. The only requirement is that an enterprise that chooses to report continuing operations separately from discontinued operations should do so consistently for all periods presented. In 2005, the U.S. Securities and Exchange Commission (SEC) noted the following diverse practices in presenting discontinued operations the cash flow statement (see Levine, 2005):

(1) Within each major category (i.e., operating, investing, and financing), combine cash flows from discontinued operations with cash flows from continuing operations (i.e., no separate classification of cash flows from discontinued operations).
(2) Separately identify cash flows from discontinued operations within each major category.
(3) Identify cash flows from discontinued operations for each major category and present them separately from cash flows from continuing operations.
(4) Aggregate into a single line item, the various cash flows that resulted from operating, investing, and financing activities associated with discontinued operations.
(5) Report within the single category of operating cash flows all the operating, investing, and financing cash flows from discontinued operations.

According to the SEC (see Levine, 2005), only presentations (1), (2) and (3) conform to SFAS-95 (see Levine, 2005, fn. 7).

[2] SFAS-95 (¶ 25) also requires multinational enterprises to report the effect of foreign currency exchange rate fluctuations on foreign currency cash balances as a separate category. This aspect of cash flow statement reporting is outside the scope of this paper.

reporting gross operating inflows and outflows under the direct method with a supplemental reconciliation of net income and NCFO is more informative than reporting NCFO under the indirect method.

A three-part solution to these problems is proposed: (1) require the direct method together with a supplemental reconciliation of net income and NCFO; (2) adopt concepts-based classification rules consistent with the economic substance of the cash flows and refine them to preclude inconsistent and contaminated classification of cash flows, distinguishing where necessary between non-financial and financial companies;[4] and (3) allocate income taxes among operating, investing, and financing activities.

Financial reporting issues are resolved only with an understanding of the purposes for which reports are prepared. So the paper begins, in the next section, with a discussion of the objectives of the cash flow statement. The stated objectives in SFAS-95 are endorsed, but the limitations those objectives impose on the usefulness of the cash flow statement are also recognized, raising points to be examined later in the paper.

Information in the SFAS-95 cash flow statement is conveyed by reporting the amounts of cash flows, classifying them by the operating, investing, and financing trichotomy, and providing NCFO, NCFI, and NCFF subtotals for each category. The paper proceeds to examine the pros and cons of the direct and indirect methods for reporting NCFO. Arguments for and against each method are evaluated, concluding with an advocacy for the direct method.

The next section of the paper examines the desirability of the SFAS-95 classification trichotomy and compares it to alternative classifications that might be made. While the distinction between cash flows generated by a business and those by financing the business is non-controversial, the distinction between operating and investing cash flows is subject to criticism. Free cash flow (FCF), defined as NCFO less part or all of NCFI, is often suggested as an alternative measure of the net cash flow from a business. The critique begins with a discussion of NCFO versus FCF, with a conclusion that supports the three-way classification.

While endorsing the SFAS-95 objectives for the cash flow statement and its three-way classification of operating, investing, and financing activities, the paper proceeds to point out major limitations of SFAS-95 that arise from its inconsistent and ambiguous implementation of that trichotomy. Indeed, a good deal of the paper focuses on these inconsistencies and ambiguities. To set

[3] See, for example, Alderman & Minyard, 1991; Munter, 1990; Munter & Moores, 1992; Nurnberg, 1993, 2003, 2004, 2006; Stewart, Ogorzelec et. al, 1988; Thompson and Bitter, 1993; Vent et al., 1995; Nurnberg & Largay, 1996, 1998.

up the discussion, a section elucidates the SFAS-95 trichotomy and, with the insistence that financial reports mirror the economics of the business, evaluates it against the trichotomy typically adopted in the finance literature.

The next section of the paper goes into more detail. Particular attention is given to the classification of interest and dividend payments and collections, purchases and sales of investments, and income tax payments. These items receive extensive consideration because their classification under SFAS-95, although largely unambiguous, is inconsistent with the finance trichotomy and lessens the usefulness of the cash flow statement. Attention is also directed to problems due to applying the same trichotomy to non-financial and financial companies. Problems also arise with a myriad of other items, and eighteen items are discussed in detail.

The paper concludes with a discussion of how users can extract information from the cash flow statement for analytical purposes. For the most part, SFAS-95 reports actual cash flows and excludes “as-if” cash flows from non-cash transactions, limiting the information content of the cash flow statement. For some purposes, however, "as-if" cash flows should be reported in the cash flow statement, because users need information about the "as-if" cash flows for analytical purposes. A section summarizes these limitations of the cash flow statement and, with user needs in mind, identifies the disclosure policies and analytical adjustments needed to rectify the deficiencies. Among those analytical adjustments is the calculation of free cash flow which analysts frequently use but which is not defined by Generally Accepted Accounting Principles (GAAP) and not reported in the cash flow statement. Finally, the conclusions are summarized in a separate section. An appendix discusses cash flow statement classification issues of non-financial versus financial companies.

[4] See Appendix A, *Non-financial versus Financial Companies*.

II. Objectives of the Cash Flow Statement

According to the FASB (SFAS-95, ¶ 4 & 100), the objective of the cash flow statement is to provide information about actual cash inflows and outflows of an enterprise classified into meaningful categories. The FASB reasoned (see, e.g., SFAS-95, ¶ 5) that information on actual cash flows is useful to help creditors, investors, and other external parties assess

(1) the ability of an enterprise to generate positive future net cash flows, meet its obligations, and pay dividends;

(2) the needs for external financing;

(3) the reasons for the differences between cash flow from operating activities and net income (or change in net assets); and

(4) the effects on financial position of cash and non-cash investing and financing activities.

As its name implies, the ostensible objective of the cash flow statement is to report actual cash flows, to the exclusion of (non-cash) transactions and events without cash flows. Much as the income statement is a historical report of revenue and expense transactions, the cash flow statement is ostensibly a historical report of actual cash flows. As a result, SFAS-95 (¶ 32 & 74) prohibits reporting non-cash investing and financing transactions in the cash flow statement, but mandates their separate disclosure. Thus an "as-if" cash flow – such as the purchase of an asset in consideration for debt (as if debt had been issued for cash and the proceeds used to purchase the assets), or the acquisition of plant assets for shares rather than cash – is precluded. However, under SFAS-95 as amended by FASB Statement 123(R), *Share-Based Payment* (SFAS-123(R), 2004, ¶ 68), the "as-if" income tax cash savings of the windfall stock option deduction is reported as a financing inflow and an operating outflow, and this paper calls for more comprehensive allocation of income taxes in the cash flow statement.[5] Of course, users are free to adjust cash flow statements further for analytical purposes by including "as-if" cash flows for non-cash transactions and other items. But such adjustments are part of financial analysis, not financial reporting of actual cash flows.[6]

[5] The windfall stock option deduction equals the excess of the total tax deduction for stock options over the total amount recognized as expense for book purposes. See Section VII D, *Income Taxes in the Cash Flow Statement*.

[6] As Penman (2003) notes, "[a]nalysts can speculate and accountants can speculate, but accountants have little comparative advantage in speculation. So, say the fundamental analysts to the accountant: Report what you know but do not mix that with speculation; leave the speculation to us. Mixing soft, speculative information with hard information only makes the task of speculation more difficult." Thus, the accountant without the comparative advantage in speculation should prepare a cash flow statement that for the most part reports actual cash flows of past periods consistent with the accountant's function

The author endorses this objective of reporting actual cash flows with several reservations, and the critique that follows is made with that understanding. However, the cash flow statement can be, and is, used for other purposes. With the aim of providing relevant information for report users, these purposes must also be accommodated.

First, for certain analytical purposes — especially for purposes of estimating shareholder value or total firm value — the exclusion of non-cash transactions and other items affects the predictability of the numbers. Accordingly, the analyst must make adjustments to the cash flow statement and, to facilitate these analytical adjustments, the cash flow statement should be supplemented with disclosures about non-cash transactions and other items.

Second, another role for the cash flow statement is to provide an alternative performance metric to the accrual based metrics in the income statement. In particular, the cash flow statement is designed to provide a cash based performance metric, in part to help report uses assess the extent to which net income is attributable to cash flows as opposed to accruals. This objective is especially important to financial analysts because vagaries in GAAP allow financial executives to manage reported earnings.

This paper examines whether the primary objective of reporting actual cash flows classified into meaningful categories is achieved by the classification rules of SFAS-95. More specifically, it examines whether the classification of cash flows under SFAS-95 is consistent with the economic substance of the underlying transactions for financial as well as non-financial companies. This paper also examines the pros and cons of the direct and indirect methods of reporting NCFO and the benefits of reporting FCF as an alternative performance metric; and the pros and cons of allocating income taxes among operating, investing, and financing activities. It also examines the reporting of non-cash transactions, FCF calculations, and analytical adjustments of the cash flow statement.

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of reporting what he or she knows. (The major exception is the "as-if" income tax effects of certain investing and financing transactions, as discussed in Section VII D, *Income Taxes in the Cash Flow Statement*.) The analyst with the comparative advantage in speculation then adjusts the cash flow statement to include "as if" cash flows for analytical purposes.

III. Direct versus Indirect Method of Reporting Net Cash Flow from Operating Activities (NCFO)

Under current practice, a key number in the cash flow statement is the subtotal NCFO. There are two methods of reporting NCFO in the cash flow statement: (1) the indirect method; and (2) the direct method. Under the indirect method, NCFO is derived by adjusting net income for non-cash revenues, non-cash expenses, and non-operating gains and losses. Under the direct method, the same NCFO is derived by adding individual categories of operating inflows, and subtracting individual categories of operating outflows. Based on the facts in Exhibit 1, the indirect method and the direct method are illustrated in Exhibits 2 and 3.

Exhibit 1: Underlying Facts

The 31 December 20x1 and 20x2 comparative balance sheet and the 20x2 income statement for XYZ Company are presented below:

31 December Balance Sheet	20x2	20x1
Cash	$ 43,000	$ 25,000
Short-term marketable securities	180,000	160,000
Accounts receivable	50,000	30,000
Allowance for uncollectible accounts	(10,000)	(5,000)
Interest receivable	3,000	2,000
Inventories	85,000	78,000
Prepaid expenses	4,000	6,000
Plant assets	260,000	240,000
Accumulated depreciation	(82,000)	(80,000)
Total assets	$ 533,000	$ 456,000
Accounts payable	$ 50,000	$ 40,000
Accrued expenses payable	18,000	15,000
Dividends payable	1,000	2,000
Interest payable	4,000	3,000
Current income taxes payable	5,000	3,000
Deferred income taxes payable	20,000	16,000
Bonds payable	160,000	150,000
Total liabilities	$ 258,000	$ 229,000
Capital stock	97,000	75,000
Retained earnings	178,000	152,000
Total stockholders' equity	$ 275,000	$ 227,000
Total liabilities and stockholders' equity	$ 533,000	$ 456,000

20x2 Income Statement		
Revenue		
Sales revenue	$ 370,000	
Interest revenue	5,000	
Total revenues		375,000
Expenses:		
Cost of goods sold	$ 95,000	
Depreciation expense	27,000	
Bad debt expense	20,000	
Interest expense	15,500	
Other expenses	141,000	
Total expenses		298,500
Net operating income		$ 76,500
Gain (loss) on sale of equipment		11,000
Gain (loss) on debt retirement		5,000
Net income before income taxes		$ 92,500
Current income tax expense	$ 33,000	
Deferred income tax expense	4,000	
Total income tax expense		37,000
Net income after income taxes		$ 55,500

Additional Information

Accounts receivable and accounts payable arise, respectively, from sales and purchases of inventories. Prepaid expenses and accrued expenses relate to other expenses. Bonded debt is acquired in the bond market and retired prematurely at a cost of $10,000. Capital stock of $8,000 is issued for plant assets. Older plant assets are sold for $21,000 cash.

Exhibit 2: SFAS-95 Indirect Method Cash Flow Statement

XYZ Company
Statement of Cash Flows
Year ending 31 December 20x2
[Indirect Method]

Operating activities:		
Net income		$ 55,500
Add expenses not using working capital:		
Depreciation	$ 27,000	
Deferred income tax expense	4,000	
Add (deduct) nonoperating losses (gains):		
Loss (gain) on sale of equipment	(11,000)	
Loss (gain) on debt retirement	(5,000)	15,000
Working capital provided by operating activities		$ 70,500
Add (deduct) changes in noncash working capital:		
Decrease (increase) in accounts receivable--net	$ (15,000)	
Decrease (increase) in interest receivable	(1,000)	
Decrease (increase) in inventories	(7,000)	
Decrease (increase) in prepaid expenses	2,000	
Increase (decrease) in accounts payable	10,000	
Increase (decrease) in accrued expenses payable	3,000	
Increase (decrease) in interest payable	1,000	
Increase (decrease) in current taxes payable	2,000	(5,000)
Net cash flow from operating activities		$ 65,500
Investing activities:		
Purchase of short-term marketable securities	$ (180,000)	
Sale of short-term marketable securities	160,000	
Purchase of plant assets	(47,000)	
Sale of plant assets	21,000	
Net cash flow from investing activities		(46,000)
Financing activities:		
Issuance of common stock	$ 14,000	
Issuance of bonded debt	25,000	
Retirement of bonded debt	(10,000)	
Dividends paid	(30,500)	
Net cash flow from financing activities		(1,500)
Net increase (decrease) in cash		$ 18,000
Cash at beginning of year		25,000
Cash at end of year		$ 43,000

Schedule of Interest Payments, Interest Collections, and Income Tax Payments
Year ending 31 December 20x2

Interest payments	$ (14,500)
Interest collections	4,000
Income taxes	(31,000)

Schedule of Noncash Investing and Financing Activities
Year ending 31 December 20x2

Common stock issued for plant assets	$ 8,000

Exhibit 3: SFAS-95 Direct Method Cash Flow Statement

XYZ Company
Statement of Cash Flows
Year ending 31 December 20x2
[Direct Method]

Operating activities:		
Collections from customers	$ 335,000	
Collections of interest	4,000	
Payments to inventory suppliers	(92,000)	
Payments to employees and suppliers	(136,000)	
Payments of interest	(14,500)	
Payments of income taxes	(31,000)	
Net cash flow from operating activities		$ 65,500
Investing activities:		
Purchase of short-term marketable securities	$ (180,000)	
Sale of short-term marketable securities	160,000	
Purchase of plant assets	(47,000)	
Sale of plant and equipment	21,000	
Net cash flow from investing activities		(46,000)
Financing activities:		
Issuance of common stock	$ 14,000	
Issuance of bonded debt	25,000	
Retirement of bonded debt	(10,000)	
Dividends paid	(30,500)	
Net cash flow from financing activities		(1,500)
Net increase (decrease) in cash		$ 18,000
Cash at beginning of year		25,000
Cash at end of year		$ 43,000

Reconciliation of Net Income and NetCash Flow from Operating Activities
Year ending 31 December 20x2

Net income		$ 55,500
Add expenses not using working capital:		
Depreciation expense	$ 27,000	
Deferred income tax expense	4,000	
Add (deduct) nonoperating losses (gains):		
Loss (gain) on sale of equipment	(11,000)	
Loss (gain) on debt retirement	(5,000)	15,000
Working capital provided by operating activities		$ 70,500
Add (deduct) changes in noncash working capital:		
Decrease (increase) in accounts receivable--net	$ (15,000)	
Decrease (increase) in interest receivable	(1,000)	
Decrease (increase) in inventories	(7,000)	
Decrease (increase) in prepaid expenses	2,000	
Increase (decrease) in accounts payable	10,000	
Increase (decrease) in accrued expenses payable	3,000	
Increase (decrease) in interest payable	1,000	
Increase (decrease) in current taxes payable	2,000	(5,000)
Net cash flow from operating activities		$ 65,500

Schedule of Noncash Investing and Financing Activities
Year ending 31 December 20x2

Common stock issued for plant assets	$ 8,000

Although the authoritative FASB and IASB pronouncements permit the indirect method, both favor the direct method. But under FASB and IASB rules, enterprises that use the direct method are required to provide a supplemental reconciliation of net income and cash flow from operating activities.[7] Thus, all enterprises subject to FASB and IASB rules must use the indirect method — either to prepare the cash flow statement itself or to prepare the supplemental reconciliation. On the other hand, companies in Australia and New Zealand are required to use the direct method and provide the supplemental reconciliation (see Australian Accounting Standards Board (AASB), 1992, ¶ 6.1), as are proprietary governmental funds in the United States (see GASB 34, 1999, ¶ 105). Surveys by the FASB and others suggest that most report users prefer the direct method. However, almost all enterprises (except Australasian enterprises and U.S. proprietary governmental funds) use the indirect method.

A. Advantages of the Indirect Method

The principal advantage of the indirect method is that it highlights the differences between net income and NCFO. Highlighting these differences is useful when using NCFO as an alternative performance metric to report the cash flow and accrual components of net income. As a result, the indirect method helps users understand the leads and lags between NCFO and net income. It highlights the operating changes in non-cash working capital accounts.[8] For example, the indirect method highlights any buildup of operating receivables (payables) that decrease (increase) NCFO relative to net income, or the reduction of operating receivables (payables) that increase (decrease) NCFO relative to net income.

An analysis of these differences is also useful to evaluate the quality of earnings. The quality of earnings is variously defined as (1) the extent to which net income represents NCFO as opposed to accruals and deferrals (see, e.g., Bernstein, 1993, p. 461), (2) the degree of conservatism in a company's reported earnings (see, e.g., White et al., 2003, p. 637), and (3) the extent to which current earnings is a good predictor of future earnings (Penman, 2007, p. 633). Analyzing differences between net income and NCFO is essential to evaluate the quality of earnings as defined in (1) above; it is by use of the reconciliation of net income and NCFO that the analyst determines the extent to which net income represents NCFO as opposed to accruals and deferrals. Due to the vagaries of GAAP, accruals

[7] Recently, the chief accountant of the SEC (Nicolaisen, 2005, p. 70) called for the preparer community to use the direct method, in order to enhance communication between public companies and interested external parties.

[8] According to PriceWaterhouseCoopers (1999, ARM 1030, §.9118), the SEC staff has indicated that presentation of cash flows from changes in working capital within the statement of cash flows is not permitted. However, the staff stated that discussion of these cash flows in MD&A is acceptable, if relevant. Accordingly, inclusion of the working capital from operations subtotal in the illustrative indirect method cash flow statements in Exhibit 2 (and in the illustrative reconciliation in Exhibit 3) is solely for illustrative purposes. It is not recommended, however, at least for public companies regulated by the SEC.

can be inflated (or deflated) and thereby impede the prediction of future earnings. On the other hand, NCFO is somewhat less subject to the vagaries of GAAP. As a result, NCFO is often viewed as the "hard" or more persistent part of earnings, whereas accruals and deferrals are the "soft" or more transitory part of earnings.

For example, Sloan (1996, pp. 297-299) examines the nature of the information contained in the accrual and cash flow components of earnings. He finds that the cash flow component of earnings exhibits higher persistence than the accrual component of earnings, and that NCFO is useful in assessing current earnings persistence. Sloan (1996) finds that for firms with large and positive accruals,

(1) earnings tend to decrease over the next three years due to accrual reversals;

(2) the largest accrual reversals are attributable to current accruals;

(3) stock prices decrease over the three-year period; and

(4) these stock price decreases are related to the predictable decrease in earnings.

Highlighting the differences between net income and NCFO under the indirect method is also useful to detect earnings management. Earnings management refers to the process used by management to report either more or less net income than would otherwise be reported. The process involves speeding up or slowing down the amount of revenues or expenses that would otherwise be recognized, and takes one of two forms: real earnings management and accounting earnings management (see Ewert & Wagenhofer, 2005, p. 1102). Real earnings management refers to the ability of management to restructure transactions to speed up or slow down the recognition of revenues or expenses. Examples include speeding up or slowing down expenditures for staff training or research and development. Accounting earnings management refers to the ability of management to use the flexibility in GAAP to speed up or slow down the recognition of revenues or expenses. Because net income is used as a performance metric, management may seek to manage earnings to somehow mislead some class of stakeholders about the underlying economic performance of the company. As Healy & Whalen (1999) and Dechow & Skinner (2000) note, management seeks to manage earnings to reduce the likelihood of violating loan covenants, to meet or exceed financial analysts' consensus

earnings forecasts, to increase the company's stock price, and to increase management incentive compensation, among other reasons.[9]

Analysts also use reported differences between net income and NCFO in the reconciliation to detect real earnings management. For example, a substantial decrease in accounts receivable or a substantial increase in accounts payable may reflect a speeding up of collections from customers or a slowing down of payments to suppliers. Analysts also use reported differences between net income and NCFO in the reconciliation to detect accounting earnings management. For example, a substantial increase in inventories may indicate lots of slow moving items due to obsolescence or style changes for which losses have not been adequately accrued due to the flexibility in GAAP, a form of accounting earnings management.[10] This information is not provided under the direct method.[11]

Another supposed advantage of the indirect method (relative to the direct method) is that most of the information required to derive NCFO is ostensibly generated by accounting information systems existing when SFAS-95 was first adopted. More precisely, most of the items in the reconciliation of net income and NCFO under the indirect method are either non-cash revenues or expenses or changes in asset or liability balances ostensibly already generated by accounting information systems designed to prepare balance sheets and income statements. As a result, when initially adopting SFAS-95, most preparers concluded that the indirect method involved less work and cost to apply than the direct method. Additionally, the indirect method represents more of a continuation of past practice than the direct method, as almost all companies issued indirect method funds statements prior to issuing cash flow statements.

B. Disadvantages of the Indirect Method

The principal disadvantage of the indirect method is that it does not report actual operating inflows and outflows. It reports only one cash flow for operating activities — NCFO. For this reason, operating activities are reported net, not gross, under the indirect method. As a result, the indirect method is less informative than the direct method supplemented by a reconciliation of net income and NCFO. It also

[9] Nurnberg (2006) notes that management may seek to manage NCFO for some or all of the same reasons that it seeks to manage earnings.

[10] Under FASB-95, the reported changes in operating working capital accounts in the reconciliation of net income and NCFO are before the effects of changes in foreign currency exchange rates and business acquisitions and dispositions. For large multinational companies, those same working capital account changes cannot be calculated from a comparative balance sheet, which shows working capital account changes after the effects of changes in foreign currency exchange rates and business acquisitions and dispositions.

[11] However, information on operating inflows and outflows under the direct method is also useful to detect real earnings management. For example, by examining differences between R&D expense and R&D outlays (reported under the direct method) over time, analysts can better assess whether a company is increasing or decreasing its R&D programs than just by looking at R&D expense alone.

is criticized (see, e.g., Smith & Freeman, 1996, p.19) for repeating information already presented in the income statement and the comparative balance sheet.

The reconciliation of net income and NCFO under the indirect method includes additions (subtractions) for decreases (increases) in operating receivables, inventories, and prepaid expenses, and increases (decreases) in operating payables. These additions and subtractions highlight the cash flow versus accrual components of net income, but they are technical adjustments of net income to derive NCFO; they are not themselves cash flows. Unfortunately, these reconciling adjustments frequently generate unwarranted inferences and tend to be confusing to some report users. For example, although they know better, some analysts (e.g., Brigham & Gapenski (1993, p. 677; Weston et al. (1996, p. 91-92) and other financial writers carelessly and incorrectly describe these additions and subtractions as operating cash inflows and outflows.[12] In fact, these additions and subtractions are merely technical adjustments of net income to derive NCFO. Operating cash inflows include customer collections, and operating cash outflows include payments for goods and services. Operating receivables result from sales on account; increases in operating receivables are subtractions in the reconciliation, but they are not operating cash outflows to customers or suppliers. Similarly, inventories result from purchases or production of goods; decreases in inventories are additions in the reconciliation, but they are not operating cash inflows from customers or suppliers. Finally, operating payables such as trade payables to suppliers result from purchases on account; increases in such operating payables are additions in the reconciliation, but they are not operating cash inflows from customers or suppliers. In part because of these unwarranted inferences, the indirect method is less understandable than the direct method (Smith & Freeman, 1996, pp. 18-19).

Another long recognized but little discussed problem with the indirect method is the absence of an external referent to which reported NCFO may be compared.[13] As a result, changes in certain balance sheet accounts are added to or subtracted from net income to derive NCFO, but the resulting NCFO amount is not subject to external validation; verification is limited to retracing the steps leading up to the derivation of NCFO. An example is adding the entire increase in accounts payable to net

[12] Thus, Brigham & Gapenski (1993, p. 677) write that "[t]he starting point in preparing a statement of cash flows is to determine the change in each balance sheet account, and then to record it as either a source or a use of funds…" Similarly, Weston et al. (1996, p. 91-92) write that "[t]he amount of net income plus depreciation is the primary operating cash flow, but changes in accounts payable, accounts receivable, inventories, and accruals are also classified as operating cash flows because these accounts are directly affected by the firm's day-to-day operations…[T]he increases in inventories and investments in receivables during the year accounted for a combined use of funds…"

[13] Chambers (1966) criticized reporting plant assets at unamortized cost as similarly lacking in external validity. That is, unamortized cost cannot be compared to any real world value; the only verification to which it is subject is retracing the steps taken to derive it.

income, including an increase in amounts owing to equipment suppliers. The resulting cash flow statement subtotals add up to the change in cash for the period, but NCFO is overstated with an offsetting overstatement of investing outlays for equipment. Similarly, other changes in balance sheet accounts may be improperly added to or subtracted from net income to derive NCFO when they should be adjustments of amounts reported as investing or financing flows. On the other hand, because the direct method reports gross operating inflows and outflows, they are real-world numbers subject to external validation. As a result, any cash flow statement misclassifications are more likely to be identified and corrected under the direct method than under the indirect method.

To preclude such misclassifications, adjustments of net income under the indirect method necessitate extensive after-the-fact analysis of all significant non-operating transactions that are buried in operating assets and liabilities. Merchandisers and manufacturers, for example, should analyze accounts payable to exclude any material change in amounts owing to equipment suppliers (as opposed to inventory suppliers) over the period; otherwise, the change in accounts payable will not equal the difference between purchases of and payments for inventory during the period.[14] Adjustments due to this after-the-fact analysis creates dissonance between the indirect method cash flow statement and comparative balance sheets; the change in accounts payable is reported as one amount in the cash flow statement and reflected as a different amount in the comparative balance sheet.

Additionally, when the bad debts provision is included as an add-back adjustment in the reconciliation of net income and NCFO, the increase (decrease) in operating receivables is before the bad debt provision, but it is almost always described succinctly as just the increase (decrease) in receivables. As a result, the increase (decrease) in receivables reported in the cash flow statement does not equal the difference in the net receivables balances reflected in comparative balance sheets. This creates additional dissonance between the cash flow statement and successive balance sheets.[15] As

[14] For example, in Exhibit 1, assume that accounts payable to equipment suppliers increased $4,000 during 20x1, but is included in $10,000 accounts payable increase and otherwise ignored in preparing the cash flow statement. In the context of the indirect method cash flow statement in Exhibit 2, the reconciling addition for the increase in accounts payable should have been $6,000, not $10,000. As a result, NCFO is really $59,500, not $63,500; and outlays for plant and equipment are really $43,000, not $47,000. In the context of the direct method cash flow statement in Exhibit 3, payments to inventory suppliers should have been $96,000, not $92,000; and outlays for plant and equipment are really $43,000, not $47,000. Reported NCFO is subject to external verification under the direct method but not the indirect method; outlays for plant and equipment are subject to external verification under both method.

[15] For example, in the context of the indirect method cash flow statement in Exhibit 2, assume that the $20,000 bad debt expense is added back to the $52,500 net income. In order to derive the $63,500 NCFO, the reconciliation will report a $35,000 subtraction for the increase in accounts receivable before the bad debt provision, equal to the excess of the $370,000 of sales revenue over the $335,000 of customer collections for the period. Accordingly, the $35,000 subtraction for the increase in receivables in the cash flow statement differs from the $15,000 net increase reflected in the comparative balance sheet.

Nurnberg (1989, pp.64-65) notes, for domestic companies without business acquisitions or dispositions, the increase (decrease) in operating receivables before the bad debt provision really represents the difference between customer collections and customer billings; accordingly, user understanding would be enhanced by describing the adjustment as excess of customer billings over customer collections (or excess of customer collections over customer billings). Similarly, the decrease (increase) in inventories and increase (decrease) in operating payables should be combined as a single positive (negative) adjustment and more fully described as excess of operating expenses over operating payments (or excess of operating payments over operating expenses). To some extent, the prescribed use of changes in balance sheet account captions under SFAS-95 rather than these more understandable captions in the reconciliation under the indirect method reflects vestiges of the now defunct statement of changes in financial position that permeate the cash flow statement (see Heath, 1988, p. 116).

Similarly, additions (subtractions) in the reconciliation for decreases (increases) in operating receivables and decreases (increases) in operating payables, inventories, and prepaid expenses exclude the effects on these accounts of business acquisitions and dispositions and, for multinational companies, the effects on these accounts of foreign currency exchange rate fluctuations. When there are acquisitions, dispositions, or foreign currency exchange rates fluctuations, the additions (subtractions) in the reconciliation differ further from the changes in the receivables, payables and inventories reflected in comparative balance sheets. This creates still more dissonance between the cash flow statement and successive balance sheets. Excluding the effects of business acquisitions and dispositions and foreign currency exchange rate fluctuations also requires considerable after-the-fact analysis, thereby further complicating the application of the indirect method.

The extensive after-the-fact analysis required to exclude the effects of non-operating transactions, business acquisitions and dispositions, and foreign currency rate fluctuations from the balance sheet account changes included in the reconciliation of net income and NCFO under the indirect method lead some commentators (e.g., Bahnson et al (1996, p. 12) to conclude that the supposed ease of applying the indirect method and the supposed difficulties of applying the direct method are more apparent than real; and that the cost of applying the indirect method may equal or exceed the cost of applying the direct method due to this extensive after-the-fact analysis.

C. Advantages of the Direct Method

SFAS-95 (¶ 107) notes that the principal advantage of the direct method is that it is more informative than the indirect method because it reports operating cash receipts and payments. In a fundamental

sense, the direct method is finer, or more informative, than the indirect method (see, e.g., Cushing, 1977, p. 310). The direct method with the reconciliation provides all the information provided by the indirect method plus information on gross operating inflows and outflows. Accordingly, report users could effortlessly transform a direct method cash flow statement into an indirect method cash flow statement. However, report users cannot effortlessly transform an indirect method cash flow statement into a direct method cash flow statement because information on gross operating inflows and outflows is not provided. Accordingly, the direct method is finer, or more informative, than the indirect method.

SFAS-95 (¶ 107) suggests that information on operating cash inflows and outflows may be useful in estimating future operating cash flows:

> The relative amounts of major classes of revenues and expenses and their relationship to other items in the financial statements are presumed to be more useful than information only about their arithmetic sum—net income—in assessing enterprise performance. Likewise, amounts of major classes of operating cash receipts and payments presumably would be more useful than information only about their arithmetic sum—net cash flow from operating activities—in assessing an enterprise's ability to generate sufficient cash from operating activities to pay its debt, to reinvest in its operations, and to make distributions to its owners.

Krishnan & Largay (2000, pp. 222-31) empirically demonstrate that gross amounts of cash inflows and outflows under the direct method are more relevant than information about net flows under the indirect method to predict future cash flows; that past cash flow data are more useful than past earnings and other accrual data in predicting future cash flows; and that the accuracy of cash flow prediction is enhanced when both direct method cash flow data and earnings and other accrual data are used. Krishnan & Largay (2000, pp. 218-219) also note the following additional advantages of having information on gross operating inflows and outflows:

> (1) the ability to compare similar types of cash receipts and payments across companies at least annually (Richardson, 1991);
>
> (2) better representation of an entity's cash cycle for credit-grantors and more user-friendly format for managers not possessing substantial accounting knowledge (O'Leary, 1988);
>
> (3) helpful in cash flow variance analysis as the cash budget can be tied into the cash flow report thereby drawing attention to the real source of any problems (Trout et al., 1993); and
>
> (4) facilitation of sensitivity analysis of cash flows to volume changes as gross cash receipts and cash payments may respond differently to changes in activity (Cornell and Apostolou, 1992).

The staff of the Office of Chief Accountant of the U.S. Securities and Exchange Commission (2005) also believes that the direct method provides investors with more useful information than the indirect method.

The direct method is also more understandable than the indirect method (see Knutson, 1993, pp. 65-67; Smith & Freeman, 1996, pp. 18-19). The numerous adjustments of net income to derive NCFO under the indirect method regularly befuddle many report users and even some preparers, especially the additions (subtractions) for some changes in assets and liabilities but not for others. On the other hand, adding individual categories of operating inflows and subtracting individual categories of operating outflows under the direct method is understandable even to report users with little or no training in financial accounting. Smith & Freeman (1996, p.19) report, however, that some users find the direct method cash flow statement more understandable with the reconciliation than without it.

Although many spokesmen for corporate management claimed that the direct method is impractical and costly to apply, accounting systems could be altered to systematically accumulate such information, as noted below. Moreover, such alterations might well be less costly to companies and less wrenching to accounting staff than recent mandated alterations of accounting systems to accumulate fair value information needed to apply more recent FASB pronouncements on financial derivatives, intangible assets, and stock options; or to conform to the requirements of the Sarbanes-Oxley Act. Indeed, surveys suggest that fewer U.S. public companies use the direct method now than in the late 1980's when SFAS-95 was first applied. Some public companies switched from the direct to the indirect method. By using the direct method, these companies implicitly found it to be practical.[16]

D. Disadvantages of the Direct Method

Those companies that use the direct method are required under SFAS-95 (¶ 30) to provide a supplemental reconciliation of net income and NCFO. As a result, the direct method requires more work than the indirect method. Additionally, some accountants caution that a direct method cash flow statement seemingly duplicates similar information presented in the income statement and thereby may undermine user perception of the usefulness of accrual basis income measurement. This misconception

[16] Another possible explanation for the switch is that corporate management was applying the direct method indirectly, by adjusting revenue and expense accounts for changes in balance sheet accounts, and concluded that the estimated gross operating inflows and outflows and resulting NCFO were inaccurate. Alternatively, the external auditors came to that same conclusion and concluded that there is more audit risk being associated with a direct method rather than an indirect method cash flow statement. However, the same or comparable inaccuracies presumably would be buried in reported NCFO under the indirect method. For both, the inaccuracies result from inaccurate or insufficient after-the-fact analysis of the changes in balance sheet accounts to ferret out the effects of non-operating transactions, business acquisitions and dispositions, and foreign currency fluctuations.

is more likely when direct method operating flows are incorrectly captioned, say, as operating revenues (rather than customer collections) or operating expenses (rather than supplier payments). For example, Myer (1980, p. 270) cautions that the direct method cash flow statement may impute to NCFO a "quasi-earnings characteristic." Similarly, Mahoney, Sever and Theis (1988, p. 29) caution that because the direct method effectively presents income statement information on a cash rather than an accrual basis, it may erroneously suggest that NCFO is as good or better performance measure than net income.

In response to the FASB Exposure Draft, which favored but did not propose to require the direct method, many spokesmen for corporate management claimed that the direct method is impractical and costly to apply. More specifically, they claimed that the direct method would require costly modifications of accounting information systems to routinely generate information on operating cash inflows and outflows not previously accumulated.[17] Additionally, few public companies issued direct method statements of changes in financial position prior to the adoption of SFAS-95 than the indirect method.

E. Genesis of GAAP Compromise

SFAS-95 (¶ 120) notes that both the direct and the indirect methods provide useful information, and one should not preclude the other. It (ibid.) favors the direct method in the cash flow statement with a supplemental reconciliation of net income and NCFO to reap the benefits of both methods but maintain the focus on cash flows in the cash flow statement.

However, SFAS-95 (¶ 120) notes that major changes in financial reporting are often evolutionary, and that many areas of financial reporting have benefited from the voluntary efforts of corporate management to improve their financial reporting practices, especially in reporting cash flows. Because of the supposed difficulties of applying the direct method, the FASB (SFAS-95, ¶ 120) opted to permit continued use of either the direct or indirect method.

[17] SFAS-95 (¶ 116) suggests that operating inflows and outflows often may be determined indirectly without incurring unduly burdensome costs over those involved in appropriately applying the indirect method. For example, customer collections could be determined indirectly by adjusting net sales revenue for bad debts expense and the change in accounts receivable (excluding the effects of foreign currency exchange rate fluctuations and business acquisitions and dispositions). SFAS-95 (¶ 118) notes, however, that few if any companies have experimented with this procedure, and the degree of difficulty encountered in applying it undoubtedly would vary depending on the nature of a company's operations and the features of its current accounting system. Additionally, considerable effort would be required to exclude the effects of non-operating transactions from changes in receivables, inventories, and payables, as noted earlier, although the same effort is required under the indirect method. Krishnan & Largay (2000, pp. 229-31) empirically cast doubt on the FASB's assertion that operating inflows and outflows can be accurately estimated indirectly from financial statement data.

F. Need for Change

SFAS-95 favors the direct method as more informative and relevant but does not require it because of the supposed difficulties in applying the direct method and the supposed ease in applying the indirect method (see SFAS-95, ¶ 114-20). As Bahnson et al (1996, p. 12) note, however, the supposed difficulties of applying the direct method and the supposed ease of applying the indirect method are more apparent then real. According to Bahnson et al (1996, p. 12), the indirect method requires extensive after-the-fact analysis to exclude from reconciling items the effects of non-operating transactions, business acquisitions and dispositions, and foreign currency rate fluctuations. Because of this after-the-fact analysis, the cost of applying the indirect method may equal or exceed the cost of applying the direct method. More importantly, the indirect method is less understandable and less informative than the direct method. In part for these reasons, Bahnson et al (1996, pp. 11-12) favor the direct method, and this writer concurs.

To apply the direct method, Bahnson et al (1996, p. 12) recommend modifying existing accounting systems to record operating inflows and outflows in nominal cash accounts. For example, collections of trade receivables would be debited to the nominal cash account “Collections from Customers," payments to suppliers of goods and services would be credited to the nominal cash account “Payments to Suppliers of Goods and Services,” and payments to employees would be credited to the nominal cash account “Payments to Employees." These nominal cash account balances would be reported as separate line items in the operating section of the cash flow statement. Investing and financing inflows and outflows would also be recorded in nominal cash accounts and reported as separate line items in the investing and financing sections of the cash flow statement.

Manifestly, mandatory use of the direct method is feasible. As noted earlier, the direct method has been used by companies in Australia and New Zealand (see AASB, ¶ 6.1) and by proprietary governmental funds in the United States (see GASB 34, ¶ 105). The direct method (together with the footnote reconciliation) provides all the information provided by the indirect method plus information on operating inflows and outflows. For this reason, the direct method is more informative than the indirect method. It is also more understandable than the indirect method (see Knutson, 1993, pp. 65-67; Smith & Freeman, 1996, pp. 18-19).

At present, investors and society in general are concerned about the integrity of financial reporting, especially income statement and balance sheet reporting, but also cash flow statement reporting. The direct method cash flow statement supplemented by the reconciliation of net income with NCFO provides a different perspective on enterprise activities than the income statement. It

serves as a check on reported net income and, more generally, enhances the integrity of financial reporting. Mandating the direct method cash flow statement supplemented by the reconciliation would make the cash flow statement more informative and more transparent than the indirect method cash flow statement, hence would enhance the integrity of financial reporting generally. It should be required.

IV. What are the Appropriate Cash Flow Classifications?

Reporting actual cash flows inevitably involves classification of cash flows, for it is that classification that enhances the information content of the cash flow statement. The cash flow statement under SFAS-95 classifies cash flows into operating, investing, and financing flows. Subsequent parts of the paper examine whether SFAS-95 identifies the appropriate cash flows within these categories. A broader issue is whether the categories themselves are appropriate.[18]

According to SFAS-95, the first objective of the cash flow statement is to provide information to help users assess the ability of the enterprise to generate positive cash flow to meet its obligations and pay dividends, and has considerable support in practice and in the finance literature. This objective implies a distinction between cash flows pertaining to the business activities and cash flows identified with (debt and equity) financing of business activities, for cash flows from business activities are used to satisfy debt and equity claims. The distinction is not controversial. Indeed, it is fundamental in financial economics: the classic Modigliani and Miller propositions deal with the distinction between cash flows of the business and those of financing the business. However, issues arise as to the distinction between cash flows from operating versus investing activities, the two components of business activities, when separate NCFO and NCFI subtotals are desired.

A. Importance of Net Cash Flow from Operating Activities

The reported subtotal NCFO is important because it is often held to be a useful measure of corporate performance. For example, Dechow (1994, 7-8, italics added) notes that in the absence of objective procedures to determine firm performance, external parties have difficulty assessing the reliability of accrual accounting signals produced by management: "On the one hand, contracting parties could demand that managers report realized cash flows. These can be objectively measured but are influenced by the timing of cash receipts and disbursements." Similarly, Cheng et al (1997, 4-5) note

[18] Additionally, providing NCFO, NCFI, and NCFF subtotals ignores the fungibility (or substitutability) of cash. Cash is fungible in the sense of being completely interchangeable. Cash collected from customers is completely interchangeable with cash collected from selling plant assets or issuing bonded debt. Absent legal or managerial restrictions, cash inflows are not ear-marked for specific uses. Thus, operating activities may have been financed with cash generated from investing or financing activities and, similarly, outlays for investing or financing activities may have been financed with cash generated from operating activities. Because of the basic fungibility of cash, the NCFO, NCFI, and NCFF subtotals are suspect; it is usually difficult if not impossible to specify what specific sources of cash are applied to specific uses. By requiring separate subtotals, SFAS-95 (and IASB-7) presupposes that offsetting inflows and outflows is meaningful, even though these subtotals imply an ordering of cash flows, e.g., operating cash inflows are used first for operating activities, and so forth. Strict reasoning might preclude offsetting inflows and outflows. From an analytical viewpoint, however, operating, investing, and financing inflows and outflows might be viewed as separate, coordinated groups of activities, with the inflows and outflows of each offset and separate subtotals reported. The problem remains to draw unambiguous distinctions among these three categories so that the subtotals are not contaminated.

that the flexibility inherent in generally accepted accounting principles enable managers to opportunistically manipulate income, whereas reported cash flow from operating activities is not subject to such manipulation and therefore may be a more reliable measure of firm performance. These and other writers suggest that reported NCFO is a more objective measure of performance than reported net income because it is less subject to manipulation.

NCFO is often used as an alternative performance metric by management and outside report users. When increases in NCFO result in higher share prices, stock-based management compensation also increases. Some managers receive cash bonuses based on improvements in NCFO. For example, Tyco International, Ltd. disclosed that its bonus plan was based in part on improvements in a defined operating cash flow metric, presumably NCFO subject to some unspecified adjustments (see Tyco's 29 January 2001 Proxy Statement, Schedule 14A, p. 38). Additionally, NCFO is often used in loan covenants with creditors.

Additionally, as used by management and outside report users, NCFO is either the numerator or denominator in several financial ratios (see, e.g., Weston and Copeland, 1992, p. 205; and Stickney et al., 2007, pp. 292, 299). Stickney (1993, p. 387-89 suggests that in three situations,[19] using NCFO to derive the cash flow interest coverage ratio is potentially more useful than using an adjusted income number to derive the traditional accrual basis interest coverage ratio to assess a firm's ability to service debt. Other financial ratios with NCFO in the numerator include the operating cash flow to total liabilities ratio and the operating cash flow to capital expenditures ratio (see Stickney, 1993, 395-97).

B. Net Cash Flow from Operating Activities versus Free Cash Flow

NCFO is the number most commonly referred to when evaluating cash flow from business activities. However, another key number often used for analytical purposes is free cash flow (FCF). This number is not defined by generally accepted accounting principles (GAAP), but is variously calculated as NCFO adjusted for certain investing flows. NCFO is the starting point for calculating free cash flow (FCF), but the definition of FCF varies widely (see, e.g., White et. al, 2003, p. 88). Typically, FCF is

[19] Stickney (1993, p. 388) defines the cash flow interest coverage ratio as NCFO plus interest payments plus income tax payments, all divided by interest payments. The three situations are when a company (1) experiences rapid growth, with additional working capital investments causing income from continuing operations to exceed cash flow from operations; (2) issues debt that does not require periodic cash interest payments, e.g., zero-coupon debt; or (3) experiences significant timing differences between pretax book income and taxable income, so that income tax expense differs from income tax payments. In other circumstances, however, the cash flow interest coverage ratio and the accrual basis interest coverage ratio (defined as income from continuing operations plus interest expense plus income tax expense, all divided by interest expense) tend to be highly correlated, and generate the same signals for report users.

defined as NCFO, sometimes adjusted by adding back interest payments net of related income tax effects, less some or all investing outflows and inflows, plus some or all investing inflows.

Several commentators (e.g., White et. al, 2003, p. 87, italics in original) suggest that FCF is a useful metric to assess firm value:

> The basic definition…is cash from operations less the amount of capital expenditures required to maintain the firm's present productive capacity. . . . The larger the firm's FCF, the healthier it is, because it has more cash available for growth, debt payment, and dividends.

Other commentators (e.g., Mulford & Comiskey (2005, p. 349) distinguish between valuation of the firm as a whole versus valuation of common stockholders' interest in the firm:

> For valuation purposes, the cash flow of interest depends on the specific asset being valued. If the model were valuing the firm as a whole, the cash flow of interest would be cash flow available to all claimants, debt holders, preferred shareholders, and common shareholders, after operating expenses and taxes had been paid. For common shareholders, the cash flow of interest would be cash available after prior claims had been serviced, including taxes, interest, and preferred dividends. . . . [T]he definition of free cash flow will depend on the claimant group for whom the measure is being defined.

Mulford & Comiskey (2005, p. 348) express concern that GAAP does not define FCF, that definitions vary as does its calculation, and that there is not much understanding by users as to what constitutes FCF. As a result, they (ibid.) suggest that there is a real risk that managers, knowing that investors and creditors are focused on FCF, will develop means to manipulate the FCF number to what investors and creditors want.[20]

Whether NCFO or FCF is the key number for analytical purposes is another way of questioning whether the distinction between operating activities and investing activities is meaningful. Some commentators (e.g., Penman, 2007, pp. 349-356) argue that FCF, defined as cash from operations less net investment outlays, is the relevant measure of net operating cash flow for an enterprise, and that the distinction between operating activities (NCFO) and investing activities (NCFI) is less important because it does not affect the calculation of FCF. They note the considerable similarities between investments in inventory (classified as NCFO under GAAP) and plant assets (classified as NCFI), and that distinguishing between the two would be less important because FCF, rather than NCFO, is the key number for assessing firm value. They (ibid., pp. 320-321) also argue that NCFO as defined by

[20] Mulford & Comiskey (2005, p. 368) also note that, because GAAP does not define FCF, the SEC requires a public company that provides FCF as a performance measure to also provide a reconciliation of FCF to the closest GAAP-based performance measure under SEC rules: "Given the many definitions of free cash flow seen in practice, these SEC-mandated reconciliations are very helpful in understanding precisely how a company has defined free cash flow."

SFAS-95 is really an accrual concept based on the distinction between capital and revenue expenditures that underlies the balance sheet and income statement but should not underlie the cash flow statement. More specifically, they argue that the distinction between operating and investing outflows depends on the distinction between revenue expenditures that go on the income statement (expenses recognized in this period) versus capital expenditures that go on the balance sheet (expenses of future periods). For example, under SFAS-95, outlays for research and development (R&D) are operating outflows because they are expensed as incurred, consistent with FASB Statement No. 2, Accounting for Research and Development Costs (SFAS-2, 1974, ¶ 12), whereas outlays for plant assets are investing outflows because they are capitalized as assets—although both expenditures are incurred in the anticipation of future economic benefits.[21]

This viewpoint has considerable merit. Concurring with this viewpoint, however, need not preclude distinguishing between operating and investing activities in the cash flow statement in order to report NCFO as an alternative performance metric. Despite some unavoidable arbitrariness, distinguishing between operating and investing activities is meaningful to report users. For, as the discussion on the objectives of the cash flow statement pointed out, analysts require a cash flow performance metric as an alternative to accrual net income, and SFAS-95 objective number (3) alludes to it. NCFO is still the number most commonly referred to when evaluating cash flow from business activities, as noted earlier.

Users continue to use both NCFO and FCF albeit for different purposes (see, e.g., Palepu et al., 2004, pp. 5-23-5-26); both could be reported in the cash flow statement. NCFO is a useful metric to assess the cash flow versus accrual components of net income; FCF is a useful metric to assess firm value. For these reasons, this writer favors continuing to distinguish among, operating, investing, and financing activities in the cash flow statement, rather than just between investing and financing activities. But the ambiguities and inconsistencies in distinguishing among these three categories

[21] This defect in NCFO results from a well-recognized limitation of accrual accounting, whereby all R&D costs are expensed as incurred, even those with anticipated future benefits beyond the current period. This defect could be eliminated, ideally, by revising SFAS-2 so that outlays for R&D with future benefits are reported as assets in the balance sheet and as investing outflows in the cash flow statement, but such a revision of SFAS-2 seems unlikely. A second best solution might be to leave SFAS-2 alone but revise SFAS-95 to report outlays for R&D costs with future benefits as investing outflows in the cash flow statement and add-back adjustments in the reconciliation of net income and NCFO. However, many other outlays are expensed immediately under GAAP, such as outlays for advertising and employee training. Because there is no objective basis for reliably measuring future benefits, the concept of reliability preempts the concept of relevance and justifies expensing these costs as incurred and treating them as operating outflows in the cash flow statement; and for conforming the classification rules for deriving NCFO in the cash flow statement to the capitalization versus expensing rules for income statement and balance sheet reporting purposes. As a result, NCFO will remain tied to accrual concept distinctions between capital and revenue expenditures.

should be eliminated, as discussed in succeeding sections of this paper. Additionally, if FCF is to be reported in and become a key cash flow statement number for assessing shareholder value and total firm value, it should be defined unambiguously for financial reporting purposes, with full disclosure of its components.[22]

[22] See Section IX, *Definition & Calculation of Free Cash Flow* and Section X D, *Free Cash Flow for Valuation Purposes*.

V. The Cash Flow Trichotomy under SFAS-95

Under SFAS-95, cash flows are reported in the cash flow statement as relating to operating, investing, or financing activities, as noted earlier. This three-way trichotomy loosely parallels one found in the finance literature, but with some important differences. The remainder of Section V summarizes the trichotomy of SFAS-95 as amended by several subsequent FASB statements,[23] followed by a discussion of its rationale and inevitable arbitrariness. Section VI compares the SFAS-95 trichotomy to that developed in financial economics.

A. Operating Activities

According to SFAS-95 (¶ 21) operating activities include all transactions and events other than investing and financing activities, and generally relate to producing and delivering goods and providing services. Operating inflows include customer collections from sales of goods and services (including trading securities and loans acquired specifically for resale), interest and dividend collections on debt and equity securities of other entities, and all other receipts not defined as investing or financing inflows, such as supplier refunds, collections on lawsuits, and most insurance proceeds. Operating outflows include interest payments (unless capitalized), payments for inventories (including trading securities and loans acquired specifically for resale), payments to employees, payments to suppliers of other goods and services, payments to settle asset retirement obligations, payments to governments for taxes, duties, fines, and other fees, and all other payments not defined as investing or financing outflows, such as customer refunds, payments under lawsuits, and charitable contributions.

B. Investing Activities

[23] As of the end of 2005, the principal FASB amendments to SFAS 95 are as follow:

(a) Statement No. 102, *Statement of Cash Flows-Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale—an amendment of FASB Statement No. 95*. (SFAS-102, 1989a)

(b) Statement No. 104, *Statement of Cash Flows-Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions—an amendment of FASB Statement*. No. 95. (SFAS-104, 1989b)

(c) Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. (SFAS-115, 1993)

(d) Statement No. 117: *Financial Statements of Not-for Profit Organizations* (SFAS-117, 1993)

(e) Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125*. (SFAS-140, 2000)

(f) Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. (SFAS-149, 2003)

(g) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. (SFAS-150, 2003)

(h) Statement No. 123 (Revised), *Stock Based Payment*. (SFAS-123(R), 2004)

Investing activities include (1) acquiring and disposing of plant assets, other productive assets, and financial investments (except cash equivalents and trading securities); and (2) making loans to and collecting loans from other entities. Investing outflows include payments to make or acquire loans, payments to acquire debt or equity securities of other entities, and payments to acquire plant assets and other productive assets. Investing inflows include receipts from collecting or disposing of loans, receipts from sales of debt or equity instruments of other entities, and receipts from sales of plant assets and other productive assets.

C. Financing Activities

Financing activities include (1) obtaining resources from owners and providing them with a return on, and a return of, their investment; (2) receiving resources that are donor restricted for long-term purposes; (3) borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and (4) obtaining and paying for other resources obtained from creditors on long-term credit. Financing inflows include proceeds from issuing debt or equity securities, proceeds from contributions and investment income that are donor restricted for long-term purposes, income tax benefits of windfall stock option deductions, receipts from certain derivative instruments with off-market terms and/or up-front payments at inception, and proceeds from other short- or long-term borrowing. Financing outflows include dividend payments, outlays to reacquire or retire equity securities, repayments of amounts borrowed, receipts from certain derivative instruments with off-market terms and/or up-front payments at inception, and payments of debt issuance costs.

D. Rationale for the SFAS-95 Trichotomy

The FASB initially developed the three-way classification of SFAS-95 as part of a proposed concepts statement on income and cash flow reporting that it issued as an Exposure Draft in 1981. Although the 1981 Exposure Draft of the proposed concepts statement did not result in the issuance of a concepts statement in the same form, the proposal for a three-way classification in the cash flow statement is retained, initially in FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises (SFAC-5, 1984, ¶ 52) on recognition and measurement, and ultimately in SFAS-95. The rationale offered by the FASB in SFAS-95 (¶ 55) is that investors and creditors consider the relationships among certain components of cash flows to be important to their analysis of financial performance. It notes [SFAS-95, ¶ 84] that classifying cash flows as operating, investing, and financing activities facilitates evaluation of significant relationships within and among these basic activities. This classification, the FASB notes [ibid.], links cash flows that are often perceived to be related, for example, cash proceeds from borrowing transactions and cash repayments

of borrowings. Thus, the cash flow statement reflects the cash flow impact of each of the major activities of the entity. Somewhat inconsistently, however, the three-way classification of SFAS-95 does not link other cash flows that are either perceived to be related or are in fact legally related.

D.1. Classification by Nature

With the exception of certain hedging transactions,[24] each cash inflow and outflow is classified according to its nature under SFAS-95. For example, management might intend to sell appreciated property and use the proceeds to retire debt. Under SFAS-95 (¶ 31), however, the inflow from the sale of the property is an investing inflow, even when the proceeds are contractually restricted to retire debt collateralized by the property, whereas the outflow for the debt retirement is a financing outflow. Similarly, proceeds from the issuance of equipment obligations are usually legally restricted to finance the acquisition of the related equipment. Under SFAS-95 (¶ 31), however, the inflow from the issuance of equipment obligations is a financing inflow, whereas the outflow for the acquisition of the related equipment is an investing outflow.

Additionally, SFAS-95 (¶ 24) notes that certain cash inflows and outflows may relate to more than one of these three categories of cash flows. In these situations, it (ibid.) suggests that the appropriate classification should be based on the activity that is likely to be the predominant source of cash flows:

> For example, the acquisition and sale of equipment to be used by the enterprise or rented to others generally are investing activities. However, equipment sometimes is acquired or produced to be used by the enterprise or rented to others for a short period and then sold. In those circumstances, the acquisition or production and subsequent sale of those assets shall be considered operating activities.

As subsequent examination will demonstrate, however, classification based on "the activity that is likely to be the predominant source of cash flows" is likely to be arbitrary.

D.2. Arbitrariness of Three-Way Classification

A major problem with the SFAS-95 three-way classification of cash flows as operating, investing, and financing is its inherent arbitrariness. From a finance perspective, acquisitions of inventories and plant assets are fundamentally alike, yet payments for the former are classified as operating cash outflows whereas payments for the latter are classified as investing cash outflows under SFAS-95. Similarly, from a finance perspective, repayments of amounts owed to suppliers and financial institutions are

[24] Under SFAS-149 (2003, ¶ 18), all cash inflows and outflows from certain derivative instruments with off-market terms and/or up-front payments at inception are reported as financing activities. For a more complete discussion of the classification of cash flows from hedging transactions, see Section VII E.17, *Hedging Transactions*.

fundamentally alike, yet the former are classified as operating cash outflows whereas the latter are classified as financing cash outflows under SFAS-95. Because cash flows from operating, investing, and financing activities are often interrelated, their classification in the cash flow statement may impede rather than enhance the analysis of cash flows by report users.

D.2.1. Operating versus Investing Activities

In a research monograph that influenced the FASB deliberations culminating in SFAS-95, Heath notes [1978, p. 129] that the purchase and sale of inventories is in one sense fundamentally the same as the purchase and sale of plant assets, in that both are usually considered part of the normal operating activities of a business, hence both might be viewed as operating activities. The case for treating the purchase and sale of plant assets differently from the purchase and sale of inventories must be based, Heath argues [ibid., p. 130], on the grounds that they are of different significance to those interested in the cash inflows and cash outflows of a business enterprise. According to Heath [ibid.], the purchase and sale of plant assets are of special significance because they are relatively infrequent, because they are often relatively large in amount, and because management is likely to have more control over the timing of them than it does over the purchase and sale of inventories. Nonetheless, Heath notes [ibid.] that distinguishing between operating and non-operating activities is likely to be troublesome.

In its 1980 Discussion Memorandum, the FASB also recognizes [1980, p. 43] the similarity of purchases of inventory and purchases of plant assets, and notes [ibid.] that one might argue that both represent investing activities. Nevertheless, the FASB [ibid., p. 44] classifies the former as an operating activity and the latter as a investing activity, largely because "…payments to suppliers for inventories are regarded normally as part of operating activities and payments for property, plant, and equipment as part of investing activities."

D.2.2. Operating versus Financing Activities

A similar problem arises in reclassifying repayments of amounts borrowed. Heath notes [1978, pp. 130-32] that some activities with a financing dimension, such as merchandise purchases on account, should be excluded from financing activities because they are spontaneous financing activities incidental to an enterprise's operations and do not affect its capital structure. According to Heath, only negotiated financing activities should be reported as financing activities. In its 1980 Discussion Memorandum, the FASB also notes [ibid., p. 43] this problem with the three-way classification.

There are at least two problems with this line of reasoning. First, it assumes that the purchase of merchandise on account always involves a current liability. Second, it assumes that report users are interested principally in the capital structure which, by definition, excludes current liabilities. What

about those admittedly less common situations where the purchase of merchandise on account involves a long-term liability? What about those report users interested in the financial structure which, by definition, includes all liabilities?

D.2.3. Investing versus Financing Activities

Finally, a similar problem arises in distinguishing between investing and financing activities. Under SFAS-95, cash flows are classified according to the transactions that cause them. Thus, the cash receipts from the sale of plant assets are an investing inflow even when the proceeds are used to retire debt — indeed, even when the proceeds are contractually restricted to retire debt collateralized by the property — because purchases and sales of plant assets are classified as investing activities. Similarly, the cash receipts from issuing debt are a financing inflow even when the proceeds are used to purchase plant assets — indeed, even when the proceeds are legally restricted to purchase the plant assets — because borrowing and repaying amounts borrowed are classified as financing activities.

VI. Comparison of the SFAS-95 Trichotomy and Finance Trichotomy

A. Overview of the Finance Trichotomy

As noted earlier, the SFAS-95 distinctions among operating, investing, and financing activities parallel similar distinctions among operating, investing, and financing decisions in the finance literature. These distinctions are made in the finance literature because it is often useful to separate investing decisions from financing decisions and to separate both from operating decisions; it is recognized, however, that these decisions are often interrelated.

Comparing the SFAS-95 trichotomy to the finance literature emanates from the decision usefulness orientation of financial reporting. Because the objective of financial reporting is to provide information that is useful in credit and investment decisions [see SFAC-1, 1978, ¶ 30-32], cash flow statements should provide information needed for credit and investment decision models. Many of these decision models are specified in the finance literature and use cash flows in financial ratios. For example, Weston and Copeland [1992, p. 205] and Stickney et al., 2007, pp. 292, 299) suggest certain financial ratios which use NCFO in either the numerator or denominator; and Palepu et al. (2004, pp.5-24-5-25) and Penman (2007, pp. 238-244) suggest various measures of FCF to assess firm value. The usefulness of these ratios as well as cash flow information generally should be enhanced when cash flow statement classifications are consistent with the way cash flows are used in credit and investment decision models in the finance literature. Analysis of cash flows may be impeded when the cash flow statement classifications do not parallel the trichotomy in the finance literature.

The finance literature notes that investing and financing decisions are interrelated [see, e.g., Brealey and Myers, 1984, pp. 443-61; and Solomon and Pringle, 1980, pp. 441-42], and that both are related to operating decisions [see, e.g., Brealey and Myers, 1984, pp. 229, 701; and Solomon and Pringle, 1980, pp. 142, 315]. Nevertheless, the finance literature posits that, for many purposes, it is useful to distinguish between investing decisions and financing decisions [see, e.g., Brealey and Myers, 1984, pp. 101, 279; and Solomon and Pringle, 1980, pp. 362, 435-41], and to separate investing and financing decisions from operating decisions [see, e.g., Solomon and Pringle, 1980, p. 315; and Palepu et al., 2004, p. 5-20]. Importantly, the finance literature typically presupposes a non-financial company when distinguishing among operating, investing and financing decisions. Additionally, the finance literature usually considers any income tax effects to be part of these decisions. The following discussion summarizes the way the finance literature distinguishes among operating, investing, and financing decisions.

A.1. Operating Decisions

Operating decisions address questions such as which goods and services to sell, which goods and services to purchase, which employees to hire and at what compensation levels, which facilities to rent, and so forth. Accordingly, operating decisions deal with the acquisition of short-term assets and the incurrence of short-term liabilities. The finance literature frequently discusses such decisions as part of working capital management.

A.2. Investing Decisions

Investing decisions address the question as to when and where to expend cash, i.e., how much a firm should invest and what specific assets a firm should invest in. Such expenditures are motivated by a desire to maximize shareholder and firm value and, as a result, are made only when the expected net present value is positive. From a finance perspective, all decisions to acquire assets used in the business are investing decisions and are fundamentally alike, whether involving long-term assets such as plant and equipment, or short-term assets such as inventories and trade receivables. Accordingly, from a finance perspective, investing decisions include the operating decisions enumerated above. For analytical purposes, however, long-term asset acquisition decisions are often viewed as investing decisions, whereas short-term asset acquisition decisions are often viewed as working capital management (operating) decisions.

A.3. Financing Decisions

Financing decisions deal with the volume and structure of a firm's financing, i.e., raising cash from investors and disposing of cash. Financing decisions address whether the cash required for investment should be generated by debt or equity securities, how excess cash balances are to be stored temporarily (see below) and, if distributed to owners, as dividends or by reacquiring its own stock. From a finance perspective, financing decisions deal with raising cash from investors for business activities and returning cash to debt and equity claimants, not the acquisition of goods (including both short- and long-lived assets) and services themselves, which are operating and investing decisions.[25] Additionally, from a finance perspective, all borrowing decisions are fundamentally alike, whether involving long-term liabilities such as mortgage and bonded debt or short-term liabilities such as bank loans and trade payables. For analytical purposes, however, long-term borrowing decisions are often

[25] From a finance perspective, a basic distinction is drawn between financing activities with investors versus operating and investing activities with customers and suppliers. A company raises cash from bondholders and stockholders to finance the business, and makes interest and dividend payments to them. It receives cash from customers and pays cash to suppliers of services and goods, including inventories and plant assets. Typically, profits are earned by trading with customers and suppliers, not investors. These distinctions coincide with the basic distinction between operating/investing and financing activities of Modigliani & Miller (M&M, 1958), which is the foundational principle in finance.

viewed as financing decisions, whereas short-term borrowing decisions are often viewed as working capital management (operating) decisions.

B. Differences between SFAS-95 and Finance Trichotomies

From the preceding, it is apparent that the SFAS-95 trichotomy differs from the trichotomy in the finance literature. Of particular concern is that SFAS-95 often results in reporting similar cash flows differently and different cash flows similarly. For example, as noted earlier, equipment outlays may be reported as operating outflows or investing outflows depending, respectively, on whether selling or renting the equipment is the predominant source of cash flows. Additionally, as discussed more fully below, NCFO and FCF of non-financial companies is contaminated by interest payments and interest and dividend collections. Similarly, NCFO of non-financial and financial companies is contaminated by the income tax effects of investing and financing activities; and FCF of non-financial and financial companies is contaminated by the income tax effects of financing activities. Subsequent sections of this paper address these issues in greater detail.

Because cash flows from operating, investing, and financing activities are often interrelated, their arbitrary classification in the cash flow statement may impede rather than enhance the analysis of cash flows by report users. Analysis of cash flows may be impeded further when the cash flow statement classifications do not parallel the trichotomy in the finance literature; or when the cash flow statement ignores differences between non-financial and financial companies.

A priori, the usefulness of the cash flow statement would be enhanced by conforming its classifications to the trichotomy in the finance literature. However, that trichotomy typically presupposes a non-financial company, as noted earlier. A somewhat different trichotomy is more appropriate for financial companies. Accordingly, cash flow statement classifications of non-financial companies should conform to the trichotomy in the finance literature; cash flow statement classifications of financial companies should conform to a somewhat different trichotomy. That is, the same cash flow statement classifications should not necessarily apply to both non-financial and financial companies.[26] As discussed more fully below, identical cash flows may be classified differently, depending on whether they are cash flows of non-financial or financial companies.

[26] The differences between non-financial and financial companies are addressed more fully in Appendix A, *Non-financial versus Financial Companies*.

VII. Particular Issues in the SFAS-95 Trichotomy

Succeeding sections of this paper examine the following cash flow statement classification issues in greater detail:

- Dividend payments
- Interest payments and related issues
  - Interest payments
  - Bonded debt
  - Debt issuance cost
  - Capitalized interest
- Interest collections
- Dividend collections
- Income taxes
- Other issues

Particular attention is devoted to examining whether the classification of the various cash flows conform to the economics of the business as discussed in the finance literature.

A. Dividend Payments

Under SFAS-95 and IASB-7, the cash flow statement classification of dividend payments does not distinguish between non-financial and financial companies. Under SFAS-95 (¶ 20(a)), except for dividend payments on mandatorily-redeemable preferred stock, dividend payments must be classified as financing outflows.[27] SFAS-95 (¶ 87) reasons that dividend payments are made for the use of equity capital; they are financing outflows because they are a direct consequence of the decision to finance with equity capital. Prior to SFAS-95, a small minority of public companies reported dividend payments as operating outflows. This practice is not permitted by SFAS-95.

Under IASB-7 (1992, ¶ 34), however, dividend payments may be classified as either financing or operating outflows. Like SFAS-95, IASB-7 reasons that dividend payments may be classified as financing outflows because they are made to obtain financial resources. Alternatively, IASB-7 (¶ 34) reasons that dividend payments may be classified as operating outflows in order to assist users' assessments of the ability of a company to pay dividends out of NCFO. Perhaps the real reason why

[27] However, under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (SFAS-150, 2003, ¶ 131), mandatorily-redeemable preferred stock is reported as a liability in the balance sheet. Formerly, it was reported in the mezzanine section between liabilities and stockholders' equity. Either way, proceeds from issuing mandatorily-redeemable preferred stock are financing inflows and payments from their redemption are financing outflows. As Mulford & Comiskey (2005, p. 131) note, however, SFAS-150 changes the SFAS-95 cash flow statement classification of dividend payments on those securities. When reported as a mezzanine item under prior practice, the dividend payments were classified as a financing outflow; now that these securities are reported as a liability, the dividend payments are classified as interest payments, an operating outflow under SFAS-95.

IASB-7 permits two alternative classifications of dividend payments is to achieve greater acceptance across countries with different classification rules and practices. Achieving greater acceptance and avoiding controversy were major objectives of many international standards issued in the early 1990's.

With full disclosure, NCFO after dividend payments under IASB-7 may be almost effortlessly adjusted by add-back to NCFO before dividend payments; indeed, companies that classify dividend payments as operating outflows under IASB-7 often report subtotals for NCFO both before and after dividend payments. Additionally, classifying dividend payments as operating outflows may assist users' assessments of the ability of a company to pay dividends out of NCFO. But classifying dividend payments as operating outflows absent other theoretical justification moves its classification from the realm of financial reporting to the realm of financial analysis. More important, from a finance perspective, dividend payments are financial outflows and should be so classified in the cash flow statement; they are made for the use of equity capital. For this reason, this paper assumes henceforth that dividend payments are financing outflows.

B. Interest Payments and Related Issues

B.1. Interest Payments

Outflows for wages, inventories, rent, and plant assets are made to generate future economic benefits. Typically, benefits from outflows for wages, inventories and rent occur in the near term, whereas benefits from outflows for plant assets occur over several periods, but these normal relationships may be reversed. For example, benefits from low turnover inventories may occur over several periods, whereas benefits from unusually short-lived plant assets may occur over just one period. For these cash outflows, the income reporting issue is whether they should be expensed or capitalized, whereas the cash flow reporting issue is whether they should be reported as operating or investing outflows. Generally, outflows for wages, inventories, and rent relate to operating activities, whereas outflows for plant assets relate to investing activities.

On the other hand, from a finance perspective, outflows for interest (and dividends) are made to service debt (and equity) capital used to finance outflows for wages, inventory, rent, and plant assets, at least for non-financial companies. The finance literature emphasizes the similarity of interest and dividend payments of non-financial companies — interest is paid for the use of debt capital, whereas dividends are paid for the use of equity capital. Clearly, for non-financial companies, interest payments result from incurring debt, a financing decision, hence are by nature financing outflows from a finance perspective. For financial companies, however, interest payments on deposit liabilities are operating

outflows, whereas interest payments of bonded debt are financing outflows, as discussed more fully below.

FASB-95 versus IASB-7 Rules

SFAS-95 does not distinguish between non-financial and financial companies; for both non-financial and financial companies, SFAS-95 classifies uncapitalized interest payments as operating outflows and capitalized interest payments as investing outflows.

In contrast, IASB-7 classification rules distinguish between financial and non-financial companies but are not uniform across either non-financial or financial companies. Under IASB-7 (¶ 33), interest payments may be classified as either operating, investing, or financing outflows of non-financial companies, and as either operating or financing outflows of financial companies. Once again, IASB-7 classification rules are flexible, in part, in order to achieve acceptance across countries with different classification rules under their own national financial accounting standards.[28]

Materiality of Interest Payments

Interest payments are often material to the separate NCFO and NCFF subtotals of non-financial companies. For example, Westinghouse reports consolidated NCFO of $693 million net of $353 million of interest payments for 1995.[29] Ignoring income taxes, if interest payments are classified instead as financing outflows, consolidated NCFO increases by 51 percent to $1.046 billion. Similarly, in its 1995 cash flow statement, Air Products and Chemicals reports NCFO of $718 million net of $99 million of uncapitalized interest payments. If interest payments are classified as financing outflows, NCFO increases by 14 percent to $817 million and NCFI decreases by 54 percent.

Interest payments are even more material to the separate NCFO and NCFF subtotals of financial companies. For example, Sovereign Bankcorp reports consolidated NCFO of negative $277.12 million net of $1.2 billion of interest payments, and positive NCFI of $1.768 billion for 2001.[30] Ignoring income taxes, if interest payments are classified instead as financing outflows,

[28] Some flexibility is also permitted for governmental units in the United States. Under GASB No. 9, Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities that Use Proprietary Fund Accounting (GASB-9, ¶ 18-25), interest payments relating to financing activities may be classified as either capital or non-capital financing outflows, whereas all other interest payments are classified as operating outflows.

[29] More completely, Westinghouse reports cash flow from continuing operations of $435 million, cash flow from discontinued operations of $258 million, interest payments on continuing operations of $214 million, and interest payments on discontinued operations of $139 million.

[30] Sovereign Bankcorp discloses $1.2 billion of interest payments. It does not disclose uncapitalized versus capitalized amounts. As a financial company, capitalized amounts are presumably small relative to uncapitalized amounts. For this reason, the above analysis assumes that the entire $1.2 billion is uncapitalized.

consolidated NCFO increases to positive $922.88 million and NCFI decreases to positive $568.41 million.

B.2. Development of SFAS-95 Rationale

In light of the conceptual argument for classifying interest payments as financing outflows by non-financial companies and its materiality for some of these companies, it is instructive to examine how SFAS-95 evolved to classify uncapitalized interest payments as operating outflows and capitalized interest payments as investing outflows for both non-financial and financial companies.

The July 1986 FASB Exposure Draft, (ED, 1986, ¶ 10(c)) classifies interest payments as operating outflows (unless capitalized). It (ED, ¶ 60) favors what Nurnberg (1993, p. 65) subsequently refers to as the inclusion concept, whereby "... cash flow from operating activities should generally reflect the cash effects of transactions and events that enter into the determination of income.... In deciding this, the Board relied on the distinction ... that dividends are distributions to owners while interest paid is an expense."

In March 1987, the FASB tentatively decided to classify [uncapitalized] interest payments as financing outflows (see FASB Action Alert No. 87-11), presumably at least by non-financial companies. In April 1987, however, the FASB returned to its original decision to classify [uncapitalized] interest payments as operating outflows (see FASB Action Alert No. 87-16). As finalized, SFAS-95 includes a single sentence footnote (¶ 17(c), fn. 7) stating that payments to acquire productive assets are investing outflows, including capitalized interest. No clarifying footnote was included in the ED. Three of the seven FASB members dissented to SFAS-95 in part because of its treatment of interest payments.

SFAS-95 (¶ 86, 89) notes that a reasonable case could be made for classifying interest payments as financing outflows, presumably at least by non-financial companies. But the FASB explains (ibid., ¶ 90) that under prior practice, almost all published funds statements implicitly classified interest payments as operating outflows (and interest collections as operating inflows).This was especially true of banks and other financial institutions. Initially, many financial institutions sought exemption from the requirement to issue cash flow statements. They argued that reporting cash flows under the SFAS-95 three-way classification is meaningless.[31] However, their request for

[31] The finance literature does not typically address the distinctions among operating, investing, and financial decisions of financial companies such as banks and investment companies. The same is true of some specialized areas of finance, such as bank management. For example, three recent bank management textbooks (Gup & Kolari, 2005; Hempel & Simonson, 1999; and Rose & Hudgins, 2005) do not discuss these distinctions; additionally, they do not list the cash flow statement as a principal financial statement of banks. Indeed, in a 3 September 2005 telephone conversation, Professor Benton E. Gup, Robert Hunt Cochrane/Alabama Bankers Chair of Finance at the University of Alabama, noted that the distinction between

exemption was denied. Subsequently, some financial companies lobbied the FASB to classify interest collections as operating inflows and interest payments as operating outflows. Otherwise, many financial companies would always report negative NCFO. One former FASB member cites this lobbying as a major reason why SFAS-95 classifies interest collections as operating inflows and interest payments as operating outflows by both non-financial and financial companies.[32]

Moreover, SFAS-95 (ibid.) perceives widespread support for the inclusion concept that it postulated in the ED. It (ibid.) explains more fully than the ED that ". . . operating cash flow should, insofar as possible, include items whose effects are included in determining net income to facilitate an understanding of the reasons for the differences between net income and NCFO."[33] Because of this inclusion concept, the FASB (ibid.) concludes that it ". . . was not convinced that changing the prevalent [prior] practice . . . would necessarily result in a more meaningful presentation of cash flows." Instead, the FASB (see ibid., ¶ 120) opted for evolutionary changes in cash flow reporting by retaining the traditional classification of uncapitalized interest payments as operating outflows by both non-financial and financial companies.[34] Neither the ED nor SFAS-95 explain the rationale for classifying capitalized interest payments as investing outflows.

B.3. Assessment of FASB Rationale

In developing SFAS-95, the FASB not only sought to accommodate financial companies that ultimately lobbied for classification rules that would enable them to report positive NCFO. The FASB also desired to develop the same classification rules for non-financial and financial companies, presumably to enhance comparability of cash flow statements across companies in different industries. Ostensibly, SFAS-95 achieves both objectives by classifying uncapitalized interest payments as operating outflows (and interest and dividend collections as operating inflows) for both non-financial and financial companies.

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investing and financing decisions is not relevant to banks; and that bank analysts and regulators do not use cash flow statements of banks for analytical purposes.

[32] See Nurnberg & Largay (1998, p. 410, fn. 4).

[33] The logic of the FASB's argument is questionable. In effect, the more items included in NCFO, the fewer the number of differences in the reconciliation of net income and NCFO under the indirect method. With fewer differences, the reconciliation is presumably easier to understand. Thus, the FASB justifies the operating classification of interest payments because it facilitates an understanding of the indirect method, notwithstanding its preference in SFAS-95 for the direct method.

[34] Support for classifying uncapitalized interest payments as operating outflows may also emanate from widespread reference to the income statement as the "statement of operations." An example is the auditor's report, which says that the "financial statements present fairly financial position, results of operations and cash flows." But as Heath notes (1978, pp. 96-103; and 1988, pp. 108-10), the income statement reports the income effects of operating activities such as sales revenues, investing activities such as gains on plant asset disposals, and financing activities such as gains on early debt extinguishments; the cash flow statement reports the cash flow effects of these same activities.

But by mandating the same classification rules for all companies, the "one size fits all" rules fit neither non-financial nor financial companies very well. Financial companies provide cash flow statements based on largely arbitrary classifications of cash flows that their own spokesmen claim are largely meaningless (see SFAS-95, ¶ 58). Non-financial companies classify uncapitalized interest payments as operating outflows and capitalized interest payments as investing outflows, although both result from the decision to finance with debt. Different classification rules for non-financial and financial companies would lead to more useful cash flow statements for both by conforming more closely to the economic substance of interest payments and how they factor into decision models in the finance literature.

Moreover, the so-called inclusion concept, with its reliance on prior practice to classify uncapitalized interest payments as operating activities, is itself inconsistently applied in SFAS-95. Net income includes many non-operating components. Including some but not all of these components in NCFO undermines the very essence of the distinctions among operating, investing, and financing activities. Gains and losses on plant asset disposals are included in net income, much like uncapitalized interest, and the cash flows from these gains and losses were usually included in operating funds flow prior to SFAS-95.[35] Consistent adherence to the inclusion concept and prior practice might have led the FASB to classify all of these cash flows as operating flows.

SFAS-95 should have consistently rejected the inclusion concept and prior practice because they reflect an income statement orientation that is inappropriate for cash flow reporting; it should have also rejected the implied objective of developing one set of classification rules for both non-financial and financial companies. Rather, the cash flow statement classification of interest payments should differ for non-financial and financial companies; for both, interest payments should be classified consistent with their economic substance within the context in which they are made. A priori, different classification rules for non-financial and financial companies that conform to the economic substance of interest payments for each should lead to more useful cash flow statements.

B.4. Non-financial versus Financial Companies

The finance literature does not adequately distinguish investing and financing decisions of non-financial companies, such as merchandise, manufacturing, or services companies, from financial companies, such as banks and investment houses. Differences between non-financial and financial

[35] Under prior practice, most companies used the indirect method to report funds flow from operations. But net income was not adjusted for non-operating gains and losses, inflows from disposals of plant assets were reported at book value and, accordingly, non-operating gains and losses were included in funds flow from operations. See Nurnberg, 1983, 810; and Ketz and Largay, 1987, 11-14.

companies should reflect differences in the nature of their operating, investing, and financing activities.[36] The cash flow statement classification of cash flows should also differ.

Non-financial Companies

Non-financial companies buy and sell goods and non-financial services; their customers purchase goods and non-financial services from them. Non-financial companies invest principally in inventory, plant assets, and intangible assets; they finance these asset acquisitions principally by purchasing goods and services on credit, and by issuing bonded debt and capital stock.

For non-financial companies, interest and dividend payments are more similar than dissimilar; they are paid for the use of debt and equity capital, respectively, hence are financing outflows from a finance perspective. Clearly, for non-financial companies, interest payments result from incurring debt, a financing decision, hence are by nature financing outflows, contrary to the SFAS-95 classification as operating outflows. SFAS-95 should be amended to classify interest payments as financing outflows for non-financial companies, because they relate to financing activities, just as cash outflows for plant assets are investing outflows because they relate to investing activities.

Financial Companies

The principal business activity of financial companies is borrowing and lending money and/or buying and selling ownership interests in financial assets; often, a principal business activity is accepting deposits and honoring withdrawals, and their customers are borrowers and depositors. Financial companies invest principally in loans and debt and equity securities; they finance these asset acquisitions principally by taking deposits and issuing bonded debt and capital stock.

For example, as Gup & Kolari (2005, p. 117) note, bank management involves daily decisions about making particular loans, about purchasing and selling securities, and about how to finance both; the traditional goal of bank management is to control a bank's net interest income with respect to interest rate risk and liquidity, often on a daily (or even more frequent) basis.[37]

[36] For diversified companies with both non-financial and financial components, the management, financial reporting, and analysis of cash flows should be component by component.

[37] According to Gup & Kolari (2005, p. 117), these daily decisions usually depend on the following considerations: (1) management expectations concerning future changes in interest rates; (2) composition of bank assets and liabilities; and (3) degree of risk bank management wants to assume. In the bank management literature, the process of making these decisions is known as asset-liability management (ALM). As the names suggest, asset management deals with determining the composition of a bank's assets, and might be viewed as the counterpart of investment decisions in the finance literature. Similarly, liability management deals with determining the composition of a bank's liabilities, and might be viewed as the counterpart of financing decisions in the finance literature. Unlike the typically long-term focus of investing and financing decisions in the finance literature, however, ALM has a very short-term, often daily, orientation. See Gup & Kolari (2005, p. 117).

For financial companies, extending and collecting (or selling) loans and/or buying and selling ownership interests in financial assets are investing activities, as under SFAS-95. Consistently, accepting deposits and honoring withdrawals are just the opposite of extending and collecting loans, hence are (negative) investing activities. Importantly, from a finance perspective, accepting deposits and honoring withdrawals are not financing activities of financial companies as under SFAS-95: they involve transactions with entities functioning principally as customers rather than as creditors; they are significantly different from obtaining debt capital from bondholders and equity capital from stockholders.

Because inflows for deposits accepted and outflows for withdrawals are (negative) investing flows, they should be included in FCF but not in NCFO. It makes no sense for FCF of financial companies to include cash flows from lending and investing activities, but to exclude cash flows from taking deposits and honoring withdrawals. SFAS-95 should be amended to classify accepting deposits and honoring withdrawals as (negative) investing activities.[38]

As Penman (2007) notes, however, for financial companies, interest payments on deposits are operating outflows, much as dividend and interest collections are operating inflows, as discussed more fully below. Because depositors and borrowers are the principal customers of financial companies, interest payments on deposit liabilities (and interest and dividend collections, as discussed more fully below) should be included in NCFO if NCFO is to be a meaningful performance metric.[39] Classifying interest payments on deposit liabilities (and interest and dividend collections of financial companies as operating flows is consistent not only with SFAS-95 but also with how these companies are managed, e.g., the traditional goal of banks to control interest income with respect to interest rate risk and liquidity.

For both financial and non-financial companies, however, bondholders are creditors; they are not customers. Borrowing from and repaying amounts to bondholders are financing activities of financial companies, not operating activities, much as they are financing activities of non-financial

[38] Because financial companies are in the business of lending and borrowing money, one could argue that operating activities include purchases and sales of loans and investments, borrowing money (including taking deposits) and repaying amounts borrowed (including withdrawals of deposits), and interest payments and interest and dividend collections. Under this schema, financial companies would have few non-operating cash flows, and most of the cash flow statement classification issues addressed in this paper would be moot. But there are good reasons to reject this viewpoint. See Appendix A.

[39] Alternatively, one could argue that accepting deposits and honoring withdrawals are financing activities of financial companies. Consistent with this viewpoint, inflows for deposits accepted and outflows for withdrawals are financing flows, consistent with SFAS-95. But there are also good reasons to reject this viewpoint. See Appendix A.

companies.[40] From a finance perspective, interest payments on bonded debt are financing outflows for both financial and non-financial companies. SFAS-95 should be amended to classify interest payments on bonded debt as financing outflows.

B.5. Additional Problems with SFAS-95 Classification of Interest Payments

Although the SFAS-95 classification of uncapitalized interest payments as operating outflows for non-financial companies can be questioned on conceptual grounds, there are also several unfortunate consequences of this requirement. Classifying uncapitalized interest payments as operating outflows and principal payments as financing outflows leads to at least four alternative methods of reporting cash flows relating to bonded debt issued at a discount or premium, and conflicts with a 1995 FASB Emerging Issues Task Force (EITF) mandate to report debt issuance cost payments as financing outflows. Classifying capitalized interest payments as investing outflows leads to at least three alternative methods of reporting cash flows relating to capitalized and uncapitalized amounts. Additionally, the required disclosure of interest payments is ambiguous. As a result, users are unable to precisely determine the amount of interest paid. These problems also weaken the ability of the cash flow statement to clearly communicate the cash flow effects of operating, investing, and financing activities, especially the subtotals, and reduce comparability across companies. These problems are discussed in the immediate succeeding subsections of this paper, in the following order: bonded debt, debt issuance costs, and capitalized interest.

B.5.1. Bonded Debt

SFAS-95 states that "repayments of amounts borrowed" are financing outflows (¶ 20(b)), whereas "payments to lenders and other creditors for interest" are operating outflows (¶ 23(d)). Over the life of a bond issue, a literal application of this provision results in differences between total financing inflows and total financing outflows whenever bonds are issued at a discount or premium, with offsetting differences between total interest expense and total interest outflows (see Stewart et al., 1988, pp.7-8; Nurnberg, 1990, pp. 52-54; and Nurnberg & Largay, 1998, pp. 407-418).

Vent et al (1995 89-96) document four alternative methods of reporting cash flows under these guidelines for bonded debt issued at a discount or premium, as follows:

> (1) Original issuance proceeds as financing inflow, principal payment at maturity as financing outflow, and periodic interest payments as operating outflows.

[40] Accepting deposits from and honoring withdrawals by customers are significantly different from obtaining debt capital from and repaying amounts to bondholders. At the margin, of course, I assume that the differences outweigh the similarities between, say, issuing five year CDs to customers and five year bonds to creditors.

(2) Original issuance proceeds as financing inflow, periodic interest payments as operating outflows, and principal payment at maturity allocated between financing outflow for original amount borrowed and (a) operating outflow for original discount or (b) operating inflow for original premium, as if repayment of debt was in part an operating transaction.

(3) Original issuance proceeds as financing inflow, principal payment at maturity as financing outflow, and periodic interest payments allocated between operating outflows for periodic interest expense and (a) financing inflows for periodic amortization of discount or (b) financing outflows for periodic amortization of premium.

(4) Principal payment at maturity as financing outflow, periodic interest payments as operating outflows, but original issuance proceeds allocated between face value of debt as financing inflow and (a) original issuance discount as operating outflow or (b) original issuance premium as operating inflow, as if borrowing was in part an operating transaction.

All four methods are found in practice (see Vent et al., 1995, pp. 94-95), and generate peculiar presentations of principal and interest payments in the cash flow statement of both non-financial and financial companies. Under Method (1), the financing outflow for repayment differs from the financing inflow from borrowing by the amount of the discount or premium, as if the original amount borrowed is overpaid by the discount or underpaid by the premium, with an offsetting difference between total interest cost and total interest outflows over the life of the bond issue. Methods (2), (3) and (4) report financing inflows for borrowings equal to financing outflows for repayments, and total interest outflows equal to total interest cost. For methods (2)(b), (3)(a) and (4)(a), however, this equality is achieved by reporting cash flows when none occur, thereby negating the objective of SFAS-95 to report cash flows only when cash in fact flows.[41] Because many companies disclose bond principal but not original issuance discount or premium, it is not always clear which method they use. Method (2)(a) for bonds issued at a discount and method (3)(b) for bonds issued at a premium appear to be most consistent with the existing SFAS-95 classification rules (see Stewart et al 1988, 7).[42] Nevertheless, both methods still generate peculiar presentations because they allocate actual cash flows between operating and financing activities. A simpler and better solution is avoiding such allocations by amending SFAS-95 to classify all interest payments on bonded debt of both non-financial and

[41] Method (4)(a) is especially questionable because it reports the original issuance discount as an operating outflow, as if interest cost is prepaid at issuance. This presentation conflicts with the long-held view (see, e.g., Paton, 1922, 415-23; and APB-21, 1971, ¶ 16) that discount is a valuation adjustment of the liability, not a prepayment of interest.

[42] The FASB staff indicates unofficially that the intent of SFAS 95 is to classify repayments of original amounts borrowed as financing outflows, at least for bonds originally issued at a discount, consistent with Method (2)(a).

financial companies, like dividend payments on stock, as financing outflows consistent with the finance literature.[43]

B.5.2. Debt Issuance Costs

As the name connotes, the FASB's Emerging Issues Task Force addressed the cash flow statement classification of debt issuance costs in Issue No. 95-13: Classification of Debt Issue Costs in the Statement of Cash Flows (FASB, EITF 95-13, 1995). EITF 95-13 cites a National Automated Accounting Retrieval Service (NAARS) search that identified 75 companies reporting a line item for debt issuance costs in their cash flow statements. Seven companies reported debt issuance costs under operating activities (e.g., the 1993 cash flow statement of Berlitz International). The other 68 companies reported debt issuance costs under financing activities, either as a separate line item (e.g., the 1993 cash flow statement of Arrow Automotive Industries) or as an offset to debt issuance proceeds (e.g., the 1992 cash flow statement of CompuCom Systems). Of course, when the lender subtracts the issuance costs from the debt issuance proceeds, there is no cash outflow reported in the cash flow statement of the borrower. Instead, the borrower reports a non-cash financing transaction in the notes to the cash flow statement if material in amount.

How debt issuance costs are classified in the cash flow statement can have a significant effect on reported NCFO. For example, Westinghouse Corporation reported a $176 million outflow for debt issuance costs among financing activities in its 1995 cash flow statement. Ignoring income taxes, if this $176 million outflow is classified as an operating outflow, cash flow from continuing operations decreases by 40.1 percent to $259 million. In contrast, Forstmann & Company's reports a $2.898 million outflow for debt issuance costs among operating activities in its 1995 cash flow statement. If this $2.898 million outflow is classified as a financing outflow, its $369 thousand NCFO increases by 785.4 percent to $3.267 million.

Whether deducted from the issuance proceeds or paid directly by the borrower, debt issuance costs are deferred and amortized to income over the life of the related borrowing. Because the

[43] Similarly, from a finance perspective, acquiring long-term debt investments is part of its investing activities, but interest collections are operating inflows. Assuming no impairment issues, under SFAS 95 the cash flow reporting by investors of held-to-maturity investments in bonded debt acquired at a discount or premium is the mirror image of the accounting by the borrower for bonded debt issued at a discount or premium, except that it involves allocating cash flows between operating and investing (rather than financing) activities. Thus, there are also four alternative methods of reporting cash flows for held-to-maturity investments in bonded debt acquired at a discount or premium under SFAS-95. Moreover, such allocations cannot be avoided, because the outlays to acquire bond investments should be classified as investing outflows whereas interest collections thereon should be classified as operating inflows under both the existing SFAS 95 and from a finance perspective. Method (2)(a) for bonds acquired at a discount and method (3)(b) for bonds acquired at a premium appear to be most consistent with both the existing SFAS 95 classification rules and a finance perspective for investors. See also Stewart et al 1988, p. 7; and Nurnberg & Largay, 1998, p. 412.

amortization is included in income and represents a cost of borrowing, the FASB staff unofficially recommended classifying debt issuance costs, like interest costs, under operating activities, consistent with the inclusion concept discussed previously. In Issue No. 95-13, however, the EITF concludes that debt issuance costs should be classified as financing outflows because they result from borrowings.[44]

EITF 95-13 represents current authoritative GAAP, as the FASB staff view is unofficial. More importantly, EITF 95-13 is consistent with the treatment of interest payments on bonded debt in financial decision making; both represent borrowing costs, hence are financing outflows from a finance perspective. Eliminating this inconsistency between SFAS-95 and EITF-95 is another reason why SFAS-95 should be amended to classify all payments relating to bonded debt financing as financing outflows, including payments for interest, principal, and debt issuance costs.[45]

B.5.3. Capitalized Interest

Under FASB Statement 34, "Capitalization of Interest Cost" (SFAS 34, 1979), interest cost is capitalized on qualifying assets requiring time to get them ready for their intended use. SFAS-95 (¶ 17(c), note 7) classifies uncapitalized interest payments as operating outflows and capitalized interest payments as investing outflows by both non-financial and financial companies. But total interest payments often differ from total interest cost due to differences in timing of payment versus recognition of cost due to accruals or deferrals and discount or premium amortization. SFAS-95 provides no guidance for measuring operating and investing components in these situations. The distinction is important for purposes of deriving NCFO but not FCF under SFAS-95. Because of ambiguities in distinguishing between uncapitalized and capitalized interest payments under SFAS-95, Nurnberg & Largay (1998, pp. 407-418) note that financial statement users cannot unambiguously distinguish between operating and investing cash flows under SFAS-95.

To illustrate, assume total interest cost of $30,000, including $3,000 of accrued interest or discount amortization and $27,000 of interest payments. Of the $30,000, $20,000 (2/3) is expensed and

[44] Unfortunately, EITF 95-13 does not fully explain the reasons for its conclusion. It notes that companies generally capitalize debt issuance costs as a deferred charge, which is amortized over the debt term, but favors classifying cash payments for debt issuance costs as financing outflows. The fact that debt issuance costs are reported as a deferred charge (among long-term assets) might be a reason for reporting them as investing outflows like other payments for long-term assets, not financing outflows, but no one makes this suggestion. Similarly, the fact that debt issuance costs are amortized to income over the debt term might be a reason for reporting them as operating outflows consistent with the treatment of interest outlays under SFAS-95, as the FASB staff suggests.

[45] Similarly, all payments relating to equity financing should be classified as financing outflows, including dividends, reacquisition costs, and stock issuance costs. Under current GAAP, stock issuance costs are reported as an offset to the issuance proceeds to which they relate, or deferred as organization cost or some other deferred charge and amortized against income. If deferred and amortized against income, stock issuance costs present the same cash flow statement classification issues as debt issuance costs.

$10,000 (1/3) is capitalized as plant assets. At least three possible cash flow presentations suggest themselves under SFAS-95. If interest payments are allocated between operating and investing activities as interest cost is allocated between amounts expensed and amounts capitalized, $18,000 (= 2/3 of $27,000) is reported as an operating outflow and $9,000 (= 1/3 of $27,000) is reported as an investing outflow. Alternatively, as little as $17,000 or as much as $20,000 could be reported as an operating outflow and as much as $10,000 or as little as $7,000 could be reported as an investing outflow, as follows:

Method	Operating	Investing	Total
(1) Proportional allocation	$18,000	$ 9,000	$27,000
(2) Minimize operating outflow	17,000	10,000	27,000
(3) Maximize operating outflow	20,000	7,000	27,000

Ernst & Whinney (1988, 24, note *) suggests reporting interest payments as operating and investing outflows in proportion to the allocation of interest cost between interest expense and capitalized interest consistent with Method (1). Nurnberg & Largay (1998, p. 414) report that companies seem to favor Method (2)—reporting all capitalized interest as investing outflow, presumably in order to minimize reported operating outflow and maximize reported NCFO. But they (ibid.) note that very few companies provide sufficient disclosures in their annual reports to ascertain the method used, let alone the dollar amounts involved; and that the differences in dollar amounts are potentially large for companies that disclose neither the method used nor the dollar amounts.

To enhance comparability across companies, at a minimum, the FASB should amend SFAS-95 and require proportional allocation. By eliminating alternative treatments, this change would reduce any tendency toward opportunistic behavior by management to manipulate reported NCFO by allocating interest payments between operating and investing activities.[46]

A simpler and better solution, however, is to amend SFAS-95 to conform more closely to the finance literature by not distinguishing between capitalized and uncapitalized interest. Whether interest cost should be expensed as incurred or capitalized under SFAS-34 is itself a controversial issue but relates to asset valuation and income reporting, not cash flow reporting.

The best solution, however, is to amend SFAS-34 to expense all interest cost in the period incurred and prohibit interest capitalization. By requiring interest capitalization, SFAS-34 confuses

[46] For a more complete discussion of the cash flow reporting of uncapitalized versus capitalized interest, see Munter and Moores, 1992, 49-55.

investment in operations with financing of operations. Additionally, when interest cost is capitalized in depreciable or amortizable assets, it affects subsequent depreciation and amortization expense; once interest cost is capitalized, it is difficult for analysts to unravel.

Under SFAS-95, dividend payments are classified as financing outflows, whether or not relating to equity capital used to finance asset acquisitions. Consistently, for non-financial companies, all interest payments should be classified as financing outflows, regardless of how SFAS-34 asset acquisitions are financed.[47] For financial companies, however, interest payments on deposit liabilities should be classified as operating outflows and interest payments on bonded debt should be classified as financing outflows, as noted earlier.

B.6. Conclusions—Interest Payments

For non-financial companies, interest payments are incurred for the use of debt capital, and dividend payments are incurred for the use of equity capital. Accordingly, proceeds from issuing debt and equity are financing inflows, and payments to retire debt and equity are financing outflows, as are interest and dividend payments thereon and payments for equity and debt issuance costs. For non-financial companies, SFAS-95 should be amended to classify all interest payments as financing outflows and excluded from both NCFO and FCF. By classifying interest payments as financing outflows, no cash flows from or to creditors need be allocated between operating and financing activities; there will be only one way to report cash flows relating to debt issued at a discount or premium, not the four alternative methods permitted under extant GAAP; and users will be able to precisely determine the amount of interest paid.

However, for financial companies, SFAS-95 should be amended to distinguish between interest payments on bonded debt and interest payments on deposit liabilities. For both non-financial and financial companies, interest payments on bonded debt should be classified as financing outflows, together with the cash flows from issuing and retiring bonded debt. But interest payments on deposit liabilities of financial companies should be classified as operating outflows and included in both NCFO and FCF of financial companies.

[47] Except for certain hedging activities, under SFAS-95 (¶ 14, note 4), each cash flow is classified according to its nature without regard to whether it relates to another item, as noted earlier. For example, the proceeds of a borrowing are a financing cash inflow whether or not the debt is intended (or even legally restricted) to finance the acquisition of long-term assets. Thus, cash flows for principal on specific construction debt should be classified like cash flows from any other debt, as financing flows, whether issued at a discount, premium, or at par. Consistent with the finance perspective, non-financial companies should classify interest payments as financing outflows, even those on construction debt issued for and restricted to fund a specific construction project.

Finally, for both non-financial and financial companies, SFAS-34 should be amended to prohibit interest capitalization. By prohibiting interest capitalization, investing in operations will be better distinguished from financing of operations.

C. Interest and Dividend Collections and Purchases and Sales of Debt and Equity Securities Investments

There is little world-wide consensus as to the cash flow statement classification of interest and dividend collections or the purchase and sale of investments in debt and equity securities. For both non-financial and financial companies, SFAS-95 classifies interest and dividend collections as operating inflows. However, dividends received from distributions in excess of earnings since acquisition are returns *of* investment, not returns *on* investment, hence are investing inflows, not operating inflows under SFAS-95 (1987, ¶ 16b). SFAS-95 (as amended by SFAS-102) distinguishes between investments in trading and non-trading securities; it does not distinguish between non-financial and financial companies, and it does not explicitly address the classification of cash flows from purchases, sales, or dividends of equity investments subject to the equity method of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (APB-18, 1971).[48] FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS-115, 1993, ¶ 12, 80) also distinguishes between investments in trading and non-trading securities.[49] SFAS-95 (as amended by SFAS-102 and SFAS-115), classifies outlays to purchase and proceeds from sale of trading securities as operating flows; and outlays to purchase and proceeds from sale of non-trading securities as investing flows.[50]

In contrast, the IASB distinguishes between financial and non-financial companies. For financial companies, IASB-7 (¶ 33) classifies interest and dividend collections as operating inflows. For non-financial companies, however, interest and dividend collections may be classified as operating or investing inflows under IASB-7 (¶ 33). For non-financial companies, IASB-7 classification rules are flexible for interest (and dividend) collections, as they are for interest (and dividend) payments, in part

[48] As SFAS-95 is applied in practice, however, dividend collections are operating inflows, including dividends on equity investments subject to APB-18, unless from distributions in excess of investee earnings since acquisition; and all purchases and sales of non-trading equity investments are investing flows, including purchases and sales of equity investments subject to APB-18. Interestingly, Mulford & Comiskey (2006) find that 13 companies (of 107 companies sampled) misclassify distributions received from equity method investee earnings since acquisition as investing rather than operating inflows, resulting in significant understatement of reported NCFO.

[49] More precisely, SFAS-115 (¶ 6) distinguishes between investments in trading securities, available-for-sale securities, and held-to-maturity securities based on management intent. Thus, non-trading securities include available-for-sale securities and held-to-maturity securities.

[50] SFAS-95 (¶ 78) also permits companies to classify certain short-term debt securities as cash equivalents. See Section VII E.11, *Cash Equivalents.*

to achieve acceptance across countries with different classification rules under their own national financial accounting standards.[51]

The finance literature distinguishes between non-financial and financial enterprises; and between investments in trading and non-trading securities. All these distinctions in the accounting and finance literature are at least potentially relevant for cash flow statement classification purposes. Succeeding subsections of this paper address the following issues: (1) trading versus non-trading securities; (2) purchases, sales and interest and dividend collections on trading securities; (3) purchases, sales and interest collections on non-trading debt securities; (4) purchases, sales and dividend collections on non-trading equity securities.

C.1. Trading versus Non-trading Securities

SFAS-115 (¶ 12, 80) distinguishes between investments in trading and non-trading securities, as follows: Trading securities are held for short periods of time; they are bought and sold to make a profit on the difference between retail and dealer, or bid and asked, prices. Implicitly, all other securities are non-trading securities. The bank management literature (see, e.g., Hempel & Simonson (1999, p. 38, 294) similarly distinguishes between investments in trading and non-trading securities of financial enterprises.

Classification Issues under Existing GAAP

Under SFAS-95 each company determines the boundaries between trading and non-trading activities, consistent with how each company manages its securities holdings. Accordingly, different companies may establish different boundaries for identical security transactions based on differences in management policies and intent. As a result, identical cash flows from the purchase or sale of identical securities may be classified differently by different companies in their cash flow statements, and comparability across companies may appear to be impaired.

Mulford & Comiskey (2005, p. 103) note that the trading desks of financial companies regularly take short-term trading positions in debt and equity securities; and that an operating classification of cash flows on these investments is appropriate under GAAP because trading activities comprise an important line of business for these financial companies. But they (ibid., pp. 103-104) contend that an operating classification of cash flows is not appropriate under GAAP when purchases and sales of short-term investments are not part of an active trading business, especially for non-financial companies that hold such securities as secondary cash reserves. Nevertheless, they (ibid) note

[51] For certain governmental units in the United States, GASB-9 (¶ 17(e), 27(c)) classifies interest and dividend collections relating to investing activities as investing inflows and all other interest and dividend collections as operating inflows.

that several companies, e.g., Ford Motor Co. in 2000 and 2001, Nautica Enterprises, Inc., in 2001, and Curtiss-Wright Corp. in 2002, classify proceeds from the sale of short-term investments as operating inflows, thereby boosting reported NCFO although without effect on FCF. This is just another example of how the classification rules under SFAS-95 (as amended) do not work very well in practice, in part because they do not adequately distinguish between non-financial and financial enterprises, or between trading and non-trading securities.

Evaluation

The apparently varied and inconsistent classification of investments in debt and equity securities appears to impair intercompany comparability, but the facts and circumstances might indicate otherwise. From a finance perspective, some companies acquire debt and equity securities with the intent to resell them at a profit as part of an established short-term trading operation. These securities are trading securities, and their purchase and sale are operating activities of these companies, not investing activities. Other companies acquire the same debt and equity securities with the intent to hold them for the intermediate- or long-term. These securities are non-trading securities, and their purchase and sale are investing activities of these companies, not operating activities.[52]

Admittedly, the distinction between trading and non-trading securities depends on management intent; and differences in management intent result in different cash flow statement classification of otherwise identical cash flows. But different classifications by different companies of the cash flows from identical security transactions reflect real-world differences in how different companies manage their security holdings. That is, they reflect real-world differences in management policy which in turn reflect real-world differences in the economics of different companies. Consistent with this reasoning, it is appropriate to report the cash flows of identical security transactions differently for different companies if one company manages these securities as trading securities (i.e., operating activities) whereas another company manages these securities as non-trading securities (i.e., investing activities).[53]

However, some non-financial companies appear to inappropriately treat securities held as secondary cash reserves as trading securities for cash flow reporting purposes, as Mulford and

[52] Still other companies may include some of the same debt securities in cash equivalents, a part of their cash management, an operating activity. These companies view the purchases and sales of certain debt securities as merely changing the form in which cash is held, an aspect of cash management, hence are operating activities. See Section VII E.11, *Cash Equivalents*.

[53] Accounting is rife with instances of identical cash flows being reported differently based on management intent. For example, the outlay to purchase a truck is an operating outflow of a truck dealer that intends to sell it but an investing outflow of a merchandiser that intends to use it to make deliveries.

Comiskey note (2005, pp. 103-104). To make the distinction between trading and non-trading securities more objective, GAAP should include a rebuttable presumption, at least for non-financial companies: all securities should be classified as non-trading securities absent persuasive evidence to the contrary. Additionally, the evidence should be documented ex-ante when the securities are acquired, not ex-post when the securities are sold. Moreover, disclosing the nature and reasons for the classification policy and presenting gross rather than net cash flows would enhance intercompany comparability and fineness of reported cash flows.

C.2. Purchases, Sales and Interest and Dividend Collections on Trading Securities

Under SFAS-95 (as amended by SFAS-102 (¶ 8) for both non-financial and financial enterprises, outlays to purchase and proceeds from sale of trading debt and equity securities are operating flows, together with interest and dividend collections thereon.[54] SFAS-102 (¶ 26) reasons that acquiring trading securities for resale is similar to merchandising companies acquiring inventories for resale; for both, the intent is to resell them at a profit. SFAS-102 (¶ 28) prohibits classifying outlays to purchase and proceeds from sale of trading securities as investing activities in order to achieve greater comparability among companies in classifying similar items. Additionally, each company determines the boundaries between trading and non-trading activities consistent with how each company manages its securities holdings, as noted above.

From a finance perspective, the purchase and sale of trading securities are more similar than dissimilar to the purchase and sale of inventories. Accordingly, the purchase and sale of trading securities are operating activities, not investing activities. It follows that outlays to purchase and proceeds from sale of trading debt and equity securities are operating flows, as are interest and dividend collections thereon, consistent with SFAS-95. Accordingly, the SFAS-95 (and IASB-7) classification of trading securities is appropriate and should not be changed. However, both SFAS-95 (and IASB-7) should provide more guidance in distinguishing trading securities from non-trading securities, especially for non-financial companies; and IASB-7 should be amended to clarify that interest and dividend collections on trading securities are operating inflows.

The analysis of the cash flow reporting of interest and dividend collections on non-trading securities is found in the next two sections, first for interest collections, then for dividend collections, with each further subdivided for non-financial versus financial companies.

[54] For both non-financial and financial companies, IASB-7 (¶ 15) explicitly classifies outlays to purchase and proceeds from sale of trading debt and equity securities as operating flows. Presumably, interest and dividend collections on trading securities are also operating flows under IASB-7, but IASB-7 is not explicit here.

C.3. Purchases, Sales and Interest Collections on Non-trading Debt Securities

The cash flow reporting of interest collections on non-trading securities should differ for non-financial versus financial companies.

C.3.1. Non-financial Companies

From a finance perspective, non-financial companies borrow or issue equity when they need cash, and often make investments in non-trading debt securities when they have excess cash balances, sometimes referred to as parking excess cash balances.[55] Presumably, acquiring (and disposing of) non-trading debt securities by non-financial companies is the opposite of borrowing, a financing activity, not an investing activity as under SFAS-95, absent evidence to the contrary. For this reason, outlays for non-trading debt securities by non-financial companies are usually financing outflows, and proceeds from their sale are financing inflows from a finance perspective. Consistently, for non-financial companies, interest collections from non-trading debt securities are financing inflows (much as interest payments are financing outflows), not operating inflows (and outflows) as under SFAS-95 (see Penman, 2007, ch. 9-10).

However, the presumption that acquiring non-trading debt securities by non-financial companies involves parking excess cash is overcome when they involve trading activities or are undertaken for some other business purpose, such as providing credit to a customer or supplier to secure some business relationship.[56] If acquiring debt securities reflect trading activities, they should be reported as operating activities, i.e., purchases generate operating outflows, and sales (and interest collections) generate operating inflows, as noted above. If such investments reflect some other business purpose, they are investing activities; the outlays to purchase and proceeds from sales are investing flows, whereas interest collections thereon are operating inflows. Classifying interest collections from non-parking investments as operating inflows by non-financial companies is consistent with classifying outlays to acquire plant assets as investing outflows, proceeds from their sale as investing inflows, and inflows from their use as operating inflows.[57]

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[55] Of course, because of the inherent price risk, non-financial enterprises do not normally acquire long-term debt investments and either short-term or long-term equity investments merely to generate a yield on excess cash balances.

[56] Alternatively, one could argue that when non-financial enterprises acquire non-trading debt (or equity) securities, they are functioning as financial companies. Consistent with this argument, outlays to acquire and inflows from sales of such investments are investing flows, interest (and dividend) collections thereon are operating inflows; and the cash flow reporting by such companies should be divided into non-financial and financial components.

[57] Customer collections from using plant assets are operating inflows, although the purchase and sale of plant assets are investing activities. Consistently, interest collections from non-trading, non-parking investments are operating inflows, although the purchase and sale of non-trading, non-parking investments are investing activities.

To the extent that non-trading debt securities involve parking excess cash by non-financial companies, analysts should exclude cash flows from their purchase and sale from FCF, along with the interest collections thereon, which should be reclassified for analytical purposes as financing inflows. Better still, SFAS-95 should be amended to conform more closely to the finance literature; for non-financial companies parking excess cash, SFAS-95 should be amended to classify outlays to acquire non-trading debt securities as financing outflows, and proceeds from their sale (and interest collections thereon) as financing inflows.

C.3.2. Financial Companies

From a finance perspective, financial companies make investments in non-trading debt securities (and make loans) to generate cash flows with positive net present values, an essential characteristic of investing activities. Financial companies invest in non-trading debt (and equity) securities (and make loans) much as non-financial companies invest in plant assets and intangibles. Accordingly, outflows for purchasing and inflows from selling such investments (and loans) are investing flows, consistent with SFAS-95; as investing flows, they should be included in FCF but not in NCFO. On the other hand, interest collections on non-trading debt securities (and loans) are operating inflows of financial companies, consistent with SFAS-95 (and SFAS-102), hence should be included in both NCFO and FCF.[58] Classifying interest collections as operating inflows by financial companies is consistent with classifying outlays for rental properties as investing outflows, proceeds from their subsequent sale as investing inflows, and rental collections as operating inflows.

However, the presumption that investments in debt securities by financial companies are investing activities is overcome when such investments reflect trading activities. If such investments reflect trading activities, they should be reported as operating activities, i.e., outflows to purchases are

[58] Certain ostensible gains and losses on non-trading debt securities acquired at a discount or premium from face value function as adjustments of the interest yield. Conceptually, they could be classified as operating inflows of financial companies and included in NCFO. Under the indirect method, they should not be backed out in the reconciliation of net income and NCFO of financial companies. For example, assume that a financial company acquires sixty-day U.S. treasury bills with a $100 million face value for $99 million. The $1 million difference represents a 1 percent yield for sixty days, or about 6 percent per year. It should be treated as an interest collection and included in NCFO, regardless of whether the books of account label it as gain or interest revenue. Other gains and losses on non-trading debt securities do not function as adjustments of the interest yield, however, and should be excluded from NCFO of financial companies and included as investing flows; they should be backed out in the reconciliation under the indirect method. The dividing line between gains and losses that function as adjustments of the interest yield and those that do not should be based on management intent in acquiring non-trading debt securities and documented at the acquisition date. The classification issue does not arise for non-financial companies that acquire non-trading debt securities to park excess cash balances, because all the cash flows would be classified as financing activities. Moreover, investments in non-trading debt securities by non-financial companies are invariably short-term and almost risk-free. Accordingly, any gains would tend to be small or immaterial, and would increase financing inflows. However, any losses would probably result from unfavorable changes in the credit worthiness of the issuer, including financial distress and/or bankruptcy, and would reduce financing inflows.

operating outflows, and inflows from sales (and interest) are operating inflows, as noted above. If such investments reflect some other business purpose, such as providing credit to a customer or supplier to secure some business relationship, they are still investing activities; the outlays to purchase and proceeds from sales are investing flows, whereas interest collections thereon are operating inflows.

C.4. Purchases, Sales and Dividend Collections on Non-trading Equity Securities

From a finance perspective, both non-financial and financial companies usually acquire non-trading equity securities for similar reasons, i.e., to generate cash flows with positive net present values, an essential characteristic of investing activities. This is true whether the positive net present values result from dividend collections and capital gains, or from securing some business relationship to enhance operating profitability.[59] Presumably, outflows for purchasing and inflows from selling non-trading equity securities are investing flows for both non-financial and financial companies, consistent with SFAS-95; as investing flows, they should be included in FCF but not in NCFO. On the other hand, dividend collections on non-trading equity securities are operating inflows for both non-financial and financial companies, consistent with SFAS-95 (and SFAS-102). Classifying dividend collections on non-trading equity securities as operating inflows is consistent with classifying outlays to acquire plant assets as investing outflows, proceeds from their sale as investing inflows, and inflows from their use as operating inflows; and with classifying outlays for rental properties as investing outflows, proceeds from their subsequent sale as investing inflows, and rental collections as operating inflows.

The presumption that acquiring non-trading equity securities is an investing activity is overcome, however, when they do in fact involve trading activities. Whenever acquiring equity securities reflect trading activities, they are operating activities. Outflows for purchases and inflows from sales of and dividends on trading equity securities are operating flows for both non-financial and financial companies, consistent with SFAS-95, as discussed previously.

D. Income Taxes in the Cash Flow Statement

Except for the income tax benefits of the windfall stock option deduction,[60] SFAS-95 (¶ 91-92) prohibits allocating income taxes among operating, investing, and financing activities in the cash flow

[59] If non-financial or financial companies make investments in non-trading equity securities for some other business purpose, such as providing equity capital to a customer or supplier, or securing some business relationship to enhance operating profitability, they are still investing activities. As such, outlays to purchase and proceeds from sales are investing flows, whereas interest collections thereon are operating inflows.

[60] As noted previously, the windfall stock option deduction equals the excess of the total tax deduction for stock options over the total amount recognized as expense for book purposes. Under SFAS-95 as amended by SFAS-123(R) (¶ 68), the income tax savings of the windfall stock option deduction are reported as a financing inflow and an operating outflow. Before this amendment, SFAS-95 treated the imputed income tax savings as a reduction of operating outflows for income tax payments, usually buried in the indirect method derivation of NCFO.

statement; all income tax payments (and refunds) are classified as operating cash flows.[61] As a result, NCFO includes the income tax effects of investing or financing activities, such as the income tax effects of gains and losses on plant asset disposals and early debt extinguishments (see Nurnberg, 1983, pp. 808-811; and Nurnberg, 2003, pp. 48-54); and FCF may be contaminated by the income tax effects of gains and losses relating to financing activities.

Some commentators (Nurnberg, 1993, 2003; Turpen & Slaubaugh, 1994; Waxman, 2003) favor amending GAAP to require income tax allocation in the cash flow statement. More precisely, they favor allocating income tax payments among operating, investing and financing activities, so that the net cash flow subtotals for each activity reflect after-tax cash flows. By allocating income taxes in the cash flow statement, the income tax effects of transactions are reported in the same section of the cash flow statement as the transactions themselves. As a result, advocates of income tax allocation in the cash flow statement (e.g., Nurnberg, 1993, p. 66; 2003, p. 54) claim that intra-period allocation results in more precisely calculated NCFO, NCFI, and NCFF subtotals.

Exhibits 4 and 5 illustrate the allocation of income taxes among operating, investing, and financing activities in the cash flow statement and the reconciliation of net income and NCFO, respectively, assuming the same facts in Exhibit 1 above. However, contrary to SFAS-95, interest payments, interest collections, and the purchase and sale of marketable securities are classified as financing flows, for reasons discussed previously, and these departures from SFAS-95 are highlighted with boldface.

[61] The cash flow statement classification of income taxes is not uniform across countries. The IASB (IAS-7, ¶ 35-36) largely conforms to SFAS 95, but permits intraperiod income tax allocation in the cash flow statement when income tax payments can be specifically identified with investing or financing activities. The British standard (FRS-1, 1996, ¶ 61) classified income tax payments in a separate category, but British companies now conform to IASB-7.

Exhibit 4: Direct Method Cash Flow Statement with Income Tax Allocation

XYZ Company
Statement of Cash Flows
Year ending 31 December 20x2
[Direct Method]

Operating activities:			
Collections from customers		$ 335,000	
Payments to inventory suppliers		(92,000)	
Payments to employees and suppliers		(136,000)	
Payments of income taxes	$ (31,000)		
Less: Tax effect of nonoperating items	**2,200**	**(28,800)**	
Net cash flow from operating activities			$ 78,200
Investing activities:			
Purchase of plant assets		$ (47,000)	
Sale of plant and equipment	$ 21,000		
Less: Tax effect of investing gain	**(4,400)**	**16,600**	
Net cash flow from investing activities			(30,400)
Financing activities:			
Issuance of common stock		$ 14,000	
Issuance of bonded debt		25,000	
Retirement of bonded debt	$ (10,000)		
Less: Tax effect of financing gain	**(2,000)**	**(12,000)**	
Interest paid less interest collected	$ (10,500)		
Less: Tax effect of net interest paid	**4,200**	**(6,300)**	
Purchase of short-term marketable securities		**(180,000)**	
Sale of short-term marketable securities		**160,000**	
Dividends paid		(30,500)	
Net cash flow from financing activities			(29,800)
Net increase (decrease) in cash			$ 18,000
Cash at beginning of year			25,000
Cash at end of year			$ 43,000

Exhibit 5: Reconciliation of Net Income and NCFO with Income Tax Allocation

XYZ Company
Reconciliation of Net Income and Net Cash Flow from Operating Activities
Year ending 31 December 20x2

Net income			$ 55,500
Add expenses not using working capital:			
Depreciation expense		$ 27,000	
Deferred income tax expense		4,000	
Add (deduct) nonoperating items:			
Interest revenue	**$ (5,000)**		
Less: Tax effect of net interest revenue	**2,000**	**(3,000)**	
Interest expense	**$ 15,500**		
Less: Tax effect of interest expense	**(6,200)**	**9,300**	
Loss (gain) on sale of equipment	$ (11,000)		
Less: Tax effect of investing gain	**4,400**	**(6,600)**	
Loss (gain) on debt retirement	$ (5,000)		
Less: Tax effect of financing gain	**2,000**	**(3,000)**	27,700
Working capital provided by operating activities			$ 83,200
Add (deduct) changes in noncash working capital:			
Decrease (increase) in accounts receivable--net		$ (15,000)	
Decrease (increase) in interest receivable		(1,000)	
Decrease (increase) in inventories		(7,000)	
Decrease (increase) in prepaid expenses		2,000	
Increase (decrease) in accounts payable		10,000	
Increase (decrease) in accrued expenses payable		3,000	
Increase (decrease) in interest payable		1,000	
Increase (decrease) in current taxes payable		2,000	(5,000)
Net cash flow from operating activities			$ 78,200

Schedule of Noncash Investing and Financing Activities
Year ending 31 December 20x2

Common stock issued for plant assets	$ 8,000

D.1. Materiality Issues

In practice, some companies disclose the income tax effects of non-operating transactions on reported NCFO. For example, Sinclair Broadcast Group Inc. discloses in the MD&A section of its 2000 10-K (p. 30) that the $69.1 million reported NCFO for 2000 is after deducting $115 million of income tax payments related to the sale of its radio broadcast assets in December 1999 and 2000, although the sales proceeds are reported as investing inflows. For Sinclair, NCFO uncontaminated by the taxes paid on this investing activity would have increased $115 million to $184.2 million, or 166.57 percent more than the $69.1 million reported amount. Similarly, in the cash flow statement in its 2001 10-K, Delmarva Power & Light Company (DPL) reports a $60.75 million NCFO and a $528.22 million investing inflow from sales of electric generating plants for 2001. In the MD&A section (p. II-11), DPL discloses that NCFO was reduced by a $77.8 million increase in income tax payments for 2001 primarily attributed to the gain on the plant sale. Accordingly, NCFO uncontaminated by income tax payments on that sale would have been as much as $138.55 million or 128.07 percent more than the $60.75 million reported amount.

Mulford & Cosmiskey (2005, pp. 175-77) estimate that the $14.215 million reported NCFO of AKI Holding Corp. for 2001 includes a $0.331 million tax benefit from a loss on the early retirement of debt; without this tax benefit, NCFO would be $13.884 million, or 2.33 percent less.[62] Similarly, they (ibid, pp. 257-60) note that Bristol-Myers Squibb Co. incurred a $1.7 billion tax on the $4.3 billion gain from the $5.0 billion sale of its Clairol Business to Procter & Gamble Co. in 2001; the $1.7 billion tax payment reduced an otherwise positive $2.645 billion NCFO to a much smaller $0.945 billion in 2002 when the tax was paid.

[62] Some companies allocate income taxes in cash flow statements despite the prohibition of SFAS-95. For example, in the cash flow statement in its 2000 10-K, Duquesne Light Company reported an investing inflow for 2000 of $1.55 billion from sales of generation assets net of federal income tax payments of $157.42 million. It also reports NCFO of $238 million for 2000. If Duquesne Light classified all income tax payments as operating outflows consistent with SFAS-95, NCFO for 2000 would decrease by $157.42 million to $80.58 million, or 66.14 percent less than the $238 million reported amount. Similarly, within investing activities of the 2000 cash flow statement in its 2000 10-K, Amcol International Corporation and Subsidiaries, reported a $654.58 million inflow from the sale of the absorbent polymers segment, followed immediately by a $75.59 million outflow for tax payments related to that sale. For 2000, Amcol also reported NCFO of $36.6 million from continuing operations and negative $327 thousand from discontinued operations, or $36.28 million total NCFO. If Amcol classified all income tax payments as operating outflows, total NCFO for 2000 would decrease by $75.59 million, from positive $36.28 million to negative $39.31 million. Presumably, Duquesne Light and Amcol allocated income taxes in the cash flow statements because reported NCFO would otherwise be misleading, but neither disclosed that fact. This writer considers tax allocation in the cash flow statement an unacceptable departure from extant GAAP, although extant GAAP is potentially misleading. Disclosing the tax effects of the investing activities would have been an acceptable practice under extant GAAP to avoid reporting misleading NCFO amounts.

D.2. Advantages of Income Tax Allocation in Cash Flow Statement

Nurnberg (2003, p. 51) calls for intraperiod income tax allocation in the cash flow statement in order to more accurately distinguish among cash flows from operating, investing, and financing activities. He (ibid.) also argues that intraperiod income tax allocation in the cash flow statement is not too complex and arbitrary, and that its benefits more than justify its costs:

> Without income tax allocation, the income tax effects of certain investing and financing cash flows are commingled with operating cash flows. . . . Without intraperiod tax allocation, NCFO is understated by the tax on gains and overstated by the tax savings on losses relating to investing and financing activities.

Consistent with the matching concept, Nurnberg (2003, p. 51) also maintains that allocating income taxes in the cash flow statement results in reporting NCFO that is uncontaminated by the tax effects of non-operating transactions, because the income tax effects of non-operating transactions are reported in the same section of the cash flow statement as those transactions themselves. Of course, this contamination problem is lessened if FCF rather than NCFO is the key number in the cash flow statement to assess firm value. FCF without income tax allocation would not be contaminated by the income tax effects of operating or investing activities, but would still be contaminated by the income tax effects of financing activities.

As long as SFAS-95 continues to prohibit tax allocation in the cash flow statement, a recommended palliative (see, e.g., Ernst and Whinney, 1988, p. 23) is to voluntarily disclose material income tax effects of gains and losses relating to investing and financing activities. Such disclosure enables report users to gauge the effect of the tax effects of non-operating gains and losses on reported NCFO. Of course, the problem with voluntary disclosure is that it usually is applied selectively, say to disclosing the tax effects of non-operating gains but not non-operating losses. Management might voluntarily disclose the income tax effects of gains relating to investing and financing activities, which would increase reported NCFO; but management might not disclose the income tax effects of losses relating to investing and financing activities, which would decrease reported NCFO.[63] This is

[63] NCFO is often used as a performance metric, as noted previously. Management usually prefers to report more NCFO rather than less NCFO. As a result, such reporting asymmetry is not surprising, i.e., voluntarily disclose (allocate) the tax effects of non-operating gains, which implies (results in) more NCFO, but do not voluntarily disclose (allocate) the tax effects of non-operating losses, which implies (results in) less NCFO. Such asymmetry in discretionary reporting practices has prevailed for decades. For a recent example, Bhattacharya et al (2003) found that pro forma earnings usually exceed GAAP earnings due to the exclusion of multiple expenses items rather than revenue items. For an early example, Bernstein (1967) found a similar asymmetry many years ago under prior GAAP, when companies could choose between the all-inclusive versus the current operating performance concepts of income; they tended to report non-operating gains in the income statement, but non-operating losses in the retained earnings statement.

intimated by the fact that three recognized experts[64] on the cash flow statement are aware of several American companies that voluntarily disclose the cash flow tax effects of gains on sales of plant assets; but none is unaware of a single American company that voluntarily discloses the cash flow tax effects of losses on sales of plant assets.[65]

D.3. Disadvantages of Income Tax Allocation in Cash Flow Statement

SFAS-95 (¶ 92) prohibits allocating income taxes in the cash flow statement because it "…would be so complex and arbitrary that the benefits, if any, would not justify the costs involved." Unmentioned by the FASB in SFAS-95 is that because corporations make estimated income tax payments quarterly under a pay-as-you go system, income tax payments frequently result from transactions of prior periods. As a result, allocating income tax payments in the cash flow statement would not necessarily result in reporting income taxes in the same periods in which the cash flows of the underlying transactions are reported. Additionally, Waxman (2004, pp. 18-19) notes hat allocating income tax payments in the cash flow statement is still more complicated when there are deferred tax assets and liabilities.

Even ignoring these complexities and asymmetries, advocates of intraperiod tax allocation in the cash flow statement ignore a fundamental difference between the income statement and the cash flow statement. The purpose of the income statement is to report periodic net income consistent with the transactions approach and the matching concept. Periodic net income equals the revenues (and gains) minus expenses (and losses) measured in accordance with accrual basis accounting, and intraperiod income tax allocation achieves a better matching of income taxes with income from continuing operations, income from discontinued operations, cumulative effects of accounting changes, extraordinary items, other comprehensive income, and prior period adjustments.

Ostensibly, the purpose of the cash flow statement is to report actual cash inflows and outflows for the period on a cash basis, not an accrual basis, and to classify actual cash flows into prescribed categories. SFAS-95 (¶ 4) notes that the primary purpose of the cash flow statement "…is to provide relevant information about the cash receipts and cash payments of an enterprise during a period." In

[64] The experts are Eugene E. Comsikey, Charles W. Mulford, and Hugo Nurnberg.

[65] As noted previously, IASB-7 (¶ 14(f), italics not in original) permits intraperiod tax allocation in the cash flow statement when income tax payments "….*can be specifically identified* with investing or financing activities." But it is not clear just what *can be specifically identified* means. However, the calculation of the income tax effects of individual transactions often involves considerable cost and effort. As a result, it is likely that this criterion will be applied lopsidedly. Management will be able to specifically identify the income tax effects of gains relating to investing and financing activities, which would increase reported NCFO; but management will be unable to specifically identify the income tax effects of losses relating to investing and financing activities, which would decrease reported NCFO.

light of that objective, SFAS-95 (¶ 49) notes that the cash flow statement should "…provide feedback about actual cash flows."

For this reason, SFAS-95 (¶ 74) prohibits the prior practice of reporting issuances of bonds or common stock in exchange for plant assets as both financing inflows and investing outflows, as if the bonds or shares were issued for cash and the cash immediately invested in plant assets.[66] It (ibid.) also prohibits reporting total plant acquisitions as investing outflows and subtracting non-cash plant acquisitions on the next line to derive net cash outflows for plant acquisitions, which would have been permitted by the Exposure Draft to SFAS-95 (ED, 1986, ¶ 20, 46-48).[67] SFAS-95 (¶ 73-74) notes that a majority of the respondents to the Exposure Draft who commented on these reporting formats

> …urged that non-cash transactions be excluded from the statement of cash flows and reported in a separate schedule. They generally said that to include those [non-cash] transactions within the [cash flow] statement would unduly complicate it and detract from its objective of providing information about an enterprise's cash receipts and cash payments during a period. The Board agreed that excluding non-cash transactions from the statement of cash flows would better achieve the statement's objective without resulting in implementation difficulties.

Thus, SFAS-95 concludes that reporting non-cash transactions is an unwarranted departure from the basic objective of the cash flow statement of reporting actual cash flows.

Reporting hypothetical (or implicit) cash flows that would or would not have occurred if related transactions had or had not occurred is a departure from the basic objective of the cash flow statement of reporting actual cash flows (see also Kirschenheiter et al. 2004, 136). When there is positive NCFO and a non-operating gain, allocating the total income tax payment into two smaller outflows is just a matter of cash flow statement classification. But when there is positive NCFO and a non-operating loss, allocating the total income tax payment into a non-operating inflow for income tax savings on the loss and a larger operating outflow is not just a matter of cash flow statement classification; hypothetical cash inflows for income tax savings are reported on those losses offset by larger hypothetical operating income tax payments. That is, reporting a hypothetical tax inflow and a tax outflow in excess of the total actual income tax payment by the absolute amount of the hypothetical tax inflow introduces into the cash flow statement a hypothetical (or implicit) inflow that never occurred in

[66] The theory underlying prior practice described both as inflows and outflows of funds, not cash. Additionally, under prior practice, the hypothetical cash inflow from the issuance of debt or common stock could be reported in a different section of the statement of changes in financial position than the hypothetical cash outflow for the plant acquisition; but disclosure was often inadequate to distinguish the cash from non-cash aspects of such transactions.

the real world. As a result, besides the added complexity and potential arbitrariness, intraperiod tax allocation in the cash flow statement results in reporting hypothetical (or implicit) cash flows, hence is contrary to the basic objective of the statement to report only actual cash flows.

It might be argued that including hypothetical (or implicit) cash flows that would or would not have occurred if related transactions had or had not occurred reduces the representational faithfulness of the cash flow statement. Moreover, permitting such hypothetical cash flows in the cash flow statement might motivate management to report more that just hypothetical tax savings. Conceivably, corporate management might start reporting all sorts of hypothetical (or implicit) cash flows, limited only to its imagination to identify hypothetical (or implicit) cash outflows that could be reported among investing or financing activities in order to boost reported NCFO; or hypothetical cash outflows that could be reported among financing activities in order to boost calculated FCF.[68]

D.4. Resolution of Conundrum

Consistent with FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* (SFAC-2, 1980b), GAAP should enhance representational faithfulness in cash flow reporting. It should also restrict opportunistic reporting by management of all sorts of hypothetical (or implicit) cash flows. To accomplish these objectives, ideally the cash flow statement should report only actual (as opposed to hypothetical) cash flows, but this ideal may not be attainable for other reasons.

Two possible resolutions to this income tax reporting conundrum suggest themselves: (1) report income tax payments in a separate fourth section in the cash flow statement; and (2) allocate income taxes in the cash flow statement notwithstanding the recognition of hypothetical cash flows. Each possibility is examined below.

D.4.1. Report Income Tax Payments in Separate Fourth Category

One possible resolution to this income tax reporting conundrum is to report income tax payments and refunds in a separate fourth category in the cash flow statement, separate and apart from the operating,

[67] The ED was unclear as to whether a company that reported non-cash acquisitions this way was also permitted or required to report total debt or common stock issuances within financing activities and subtracting non-cash issuances on the next line to derive net cash inflows from debt or common stock issuances.

[68] For example, Maremont (2002a) reports that Tyco International Ltd. spent $830 million in 2001 to buy roughly 800,000 individual customer contracts from independent dealers that it reported as an investing outflow. However, Tyco grossed up these outlays, reporting investing outflows in excess of $830 million; it reported the excess as a reduction of connection fee expense and an operating outlay reduction inflow that increased net earnings and NCFO, respectively. Such grossing up might conform to GAAP for balance sheet and income statement reporting purposes due to the vagaries of the distinction between assets and expenses under accrual basis accounting. But it is not representationally faithful in reporting actual cash flows. For 2001, Tyco made cash outflows of $830 million for dealer contracts, not more; it did not generate cash inflows from dealers for connection fees.

investing, and financing categories. This presentation of income tax cash flows in a separate section in the cash flow statement is illustrated in Exhibit 6, assuming the same facts in Exhibit 1 above; however, for reasons discussed previously, interest payments, interest collections, and the purchase and sale of marketable securities are classified as financing flows, contrary to SFAS-95, and these departures from SFAS-95 are highlighted with boldface.[69]

By reporting income tax payments in a separate fourth category, NCFO is uncontaminated by the income tax effects of any activities, let alone investing and financing activities, but is reported on a before-tax basis. Similarly, if reported in the cash flow statement, FCF is also uncontaminated by the income tax effects of any financing activities, but is also reported on a before-tax basis. Additionally, the complexities and arbitrariness of intraperiod tax allocation are avoided, and the cash flow statement reports only actual cash flows, not hypothetical (or implicit) cash flows.[70]

Before-tax NCFO (and FCF) may be more useful than after-tax NCFO (and FCF) for comparing NCFO (and FCF) trends over time for a company with a changing income tax position. Similarly, before-tax NCFO (and FCF) may be more useful than after-tax NCFO (and FCF) for comparing NCFO (and FCF) across companies in different income tax positions for one reason or another. However, differences in income tax positions may be important for a complete comparison of cash flows across time for a single company as well as for intercompany comparisons. More important, most users seem to want NCFO and FCF metrics on an after-tax basis. In particular, most valuation models (see, e.g., Palepu et al., 2004, p. 7-12-7-13; and Penman, 2007, pp. 122-127) call for NCFO (and FCF) metrics on an after-tax basis. Reporting NCFO (and possibly FCF) on a before-tax basis would seem to contravene the objective of making the cash flow statement more useful to report users by conforming it more closely to user decision models.[71]

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[69] Interestingly, reporting income tax payments in a separate fourth category was required in the United Kingdom by the Accounting Standards Board (ASB) in Financial Reporting Standard No. 1, "*Cash Flow Statement*" (ASB 1, 1996). ASB-1 (¶ 61) reasoned that "…it is not useful to divide taxation cash flows into constituent parts relating to the activities that gave rise to them because the apportionment will, in many cases, have to be made on an arbitrary basis. As taxation cash flows generally arise from activities in an earlier period, apportioning the taxation cash flows would in any event not necessarily report the taxation cash flows along with the transactions that gave rise to them. Accordingly, the [British Accounting Standards] Board believes that taxation cash flows in relation to revenue and capital profits should be disclosed in a separate section within the cash flow statement entitled 'taxation'."

[70] Any material income tax payments (or refunds) relating to investing or financing activities could be disclosed in the notes to the financial statements, including any material reduction in income tax payments from non-operating losses or the windfall stock option deduction.

[71] Moreover, users seem to want NCFO uncontaminated by the income tax effects of investing and financing activities, and FCF uncontaminated by the income tax effects of financing activities. See, e.g., Palepu et al., 2004, p. 7-12-7-13; and Penman, 2007, p. 354.

Exhibit 6: Alternative 4-Way Direct Method Cash Flow Statement with Subtotals

XYZ Company
Statement of Cash Flows
Year ending 31 December 20x2

Operating activities:		
Collections from customers	$ 335,000	
Payments to inventory suppliers	(92,000)	
Payments to employees and other suppliers	(136,000)	
Net cash flow from operating activities		$ 107,000
Investing activities:		
Purchase of plant assets	$ (47,000)	
Sale of plant and equipment	21,000	
Net cash flow from investing activities		(26,000)
Financing activities:		
Issuance of common stock	$ 14,000	
Issuance of bonded debt	25,000	
Retirement of bonded debt	(10,000)	
Interest payments	**(14,500)**	
Interest collections	**4,000**	
Purchase of short-term marketable securities	**(180,000)**	
Sale of short-term marketable securities	**160,000**	
Dividends paid	(30,500)	
Net cash flow from financing activities		(32,000)
Income taxes:		
Payments of income taxes		**(31,000)**
Net increase (decrease) in cash		$ 18,000
Cash at beginning of year		25,000
Cash at end of year		$ 43,000

Reconciliation of Net Income and NetCash Flow from Operating Activities
Year ending 31 December 20x2

Net income		$ 55,500
Add (deduct) noncash or **nonoperating** expenses (revenues):		
Depreciation expense	$ 27,000	
Current income tax expense	**33,000**	
Deferred income tax expense	4,000	
Interest revenue	**(5,000)**	
Interest expense	**15,500**	
Add (deduct) nonoperating losses (gains):		
Loss (gain) on sale of equipment	(11,000)	
Loss (gain) on debt retirement	(5,000)	
Add (deduct) changes in operating noncash working capital:		
Decrease (increase) in accounts receivable--net	(15,000)	
Decrease (increase) in inventories	(7,000)	
Decrease (increase) in prepaid expenses	2,000	
Increase (decrease) in accounts payable	10,000	
Increase (decrease) in accrued expenses payable	3,000	51,500
Net cash flow from operating activities		$ 107,000

Schedule of Noncash Investing and Financing Activities
Year ending 31 December 20x2

Common stock issued for plant assets	$ 8,000

D.4.2. Allocate Income Taxes in Cash Flow Statement

The alternative resolution of this income tax reporting conundrum is to allocate income taxes in the cash flow statement. Income tax allocation is contrary of the basic objective of reporting only actual (as opposed to hypothetical) cash flows in the cash flow statement. But such a departure seems necessary to avoid contaminating NCFO with the income tax effects of investing and financing

activities; and to avoid contaminating FCF (if reported) with the income tax effects of financing activities.

For example, without income tax allocation, NCFO and FCF would be overstated by the income tax savings from the windfall stock option deduction. This motivated the FASB (see SFAS-123(R), ¶ B224-B228) to amend SFAS-95 to require income tax allocation in the cash flow statement for the income tax savings from the windfall stock option deduction, as noted previously, although these income tax savings are hypothetical (as opposed to actual) cash inflows.[72]

The FASB should amend SFAS-95 further to require income tax allocation in the cash flow statement for all material income tax effects of investing and financing activities. That is, SFAS-95 should make a more general exception to the objective of reporting only actual (as opposed to hypothetical) cash flows and require income tax allocation in the cash flow statement. Admittedly, reporting hypothetical (as opposed to actual) cash flows in the cash flow statement might be viewed as more the province of financial analysis by report users rather than financial reporting by accountants. But accountants have a comparative advantage over report users in calculating the income tax effects of individual investing and financing activities.[73] This comparative advantage is another reason why income taxes should be allocated in the cash flow statement even though it involves reporting "as-if" cash flows.

By allocating income taxes in the cash flow statement, NCFO will not be contaminated by the income tax effects of investing and financing activities; and FCF (if reported) will not be contaminated by the income tax effects of financing activities. GAAP already makes a comparable exception (for good reasons) for recognizing hypothetical income tax effects in the income statement.[74] After all,

[72] However, except for the income tax savings from the windfall stock option deduction, the FASB reaffirms its conclusion in SFAS-95 (¶ 92) that "…allocation of income taxes paid to operating, investing, and financing activities would be so complex and arbitrary that the benefits, if any, would not justify the costs involved." See SFAS-123(R), ¶ B223.

[73] For example, users might have more difficulties than accountants in calculating the cash flow effects of the windfall stock option deduction. According to the FASB (2005), there are two ways to make the calculation (see also PwC, 2005). Neither way is simple to apply.

[74] At one time, intraperiod income tax allocation was subject to widespread controversy. More specifically, in Accounting Series Release (ASR) No. 53 (SEC, ASR-53, 1945, pp. 142-55), the SEC initially took exception to intraperiod allocation. The SEC contended that intraperiod allocation is contrary to accounting as traditionally conceived: that it is contrary to the traditionally historical cost convention and to the prescription against normalizing periodic net income; that it is not subject to objective measurement but rather involves the hypothecation of reality; that the actual facts of the situation are obscured; and that no other expense is allocated on the basis of applying to a given transaction so much of the expense as would not have occurred if the transaction to which the expense is attributed had not taken place. According to Greer (1945, pp. 98-99), critics raised far fewer objections to intraperiod allocation between two positive incomes, whereby the total initial tax charge is allocated as two smaller charges, than to intraperiod allocation between a positive and a negative income, whereby the total initial tax charge is allocated as a negative tax charge (or tax savings) and a positive tax charge in excess of the initial tax charge by the absolute amount of the negative tax charge. It was contended that the latter "introduces into the income statement an item of imaginary [hypothetical] nature, such as accountants have long sought to eliminate and

under the income tax law, income taxes are assessed on an overall company basis (i.e., on taxable income), not on a transaction by transaction basis. But income taxes are allocated in the income statement to avoid contaminating after-tax income from continuing operations with the income tax effects of discontinued operations, extraordinary items, other comprehensive income, and prior period adjustments. Similarly, income taxes should be allocated to individual operating, investing, and financing flows in the cash flow statement to avoid contaminating NCFO and FCF (if reported).

However, SFAS-95 should continue to prohibit reporting other hypothetical cash flows, especially hypothetical investing outflows that would boost reported NCFO, or hypothetical financing outflows that would boost NCFO and FCF. Otherwise, corporate management might start reporting all sorts of hypothetical cash flows, limited only to its imagination to identify hypothetical outflows that could be reported among investing activities to boost NCFO, or hypothetical outflows that could be reported among financing activities to boost NCFO and FCF.

D.5. Income Tax Refunds

Nurnberg (2003, p. 54) notes that SFAS-95 does not explicitly address the reporting or disclosure of income tax refunds. As a result, income tax payments may be reported either net or gross of income tax refunds. The cash flow statement classification issues addressed in this paper arise for both income tax payments and income tax refunds. For ease of exposition, however, this paper emphasizes situations when there are only income tax payments.

Income tax refunds may have different significance to report users than income tax payments. As Mulford & Cosmiskey (2005, p. 229) note, income tax payments are recurring if taxable income is recurring, whereas income tax refunds are nonrecurring because they are limited to taxable income of relatively short carry-back periods. Accordingly, income tax refunds are more transitory than income tax payments. Manifestly, gross disclosure of income tax refunds separate from income tax payments is more informative than net disclosure. Users would benefit from disclosure of income tax refunds separately from income tax payments.

D.6. Conclusion—Income Taxes

Under SFAS-95, except for the income tax savings from the windfall stock option deduction, income tax payments and refunds are classified as operating outflows. This classification results in contaminating NCFO with the income tax effects of investing and financing activities, and FCF (if reported) with the income tax effects of financing activities. Intraperiod tax allocation in the cash flow

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avoid." Nevertheless, the SEC has long required intraperiod allocation, which enjoys widespread acceptance for many years both in the authoritative literature and in professional practice (see Patten, 1964, pp. 876-79).

statement overcomes this defect. However, intraperiod income tax allocation would introduce a new problem into the cash flow statement: it would result in reporting hypothetical (or implicit) cash inflows for the income tax savings from non-operating losses, contrary to the basic objective of the cash flow statement of reporting only actual cash flows. It also adds complexity and is potentially arbitrary. Additionally, allocating income tax payments in the cash flow statement would not necessarily result in reporting all income tax payments in the same periods in which the cash flows of the underlying transactions are reported.

Nevertheless, conceptual purity should take a backseat to relevance here. By allocating income tax payments in the cash flow statement, NCFO would be uncontaminated by the income tax effects of gains and losses on investing and financing activities; and, if reported, FCF will be uncontaminated by the income tax effects of gains and losses on financing activities. Moreover, NCFO, NCFI, NCFF, and FCF (if reported) will be presented on an after-tax basis, consistent with report user decision models.

Additionally, for each reporting period, SFAS-95 should also be amended to require disclosure of (1) gross income tax payments separate from gross income tax refunds; (2) income tax effects of individual investing and financing transactions; and (3) a reconciliation of the income tax effects of individual investing and financing transactions with the net income tax payment or refund. Financial report users would also benefit from disclosure of the total income tax effects of individual investing and financing transactions, distinguishing between actual tax payments or refunds of the current period with those of past or future periods. That way, users could adjust the actual after-tax NCFO (and possibly after-tax FCF) to a more prospective basis for analytical purposes.[75] Finally, users would benefit from disclosure of the reasons for any significant leads and lags between the net income tax paid (or refunded) and the expected income tax effects of these transactions.

E. Other Classification Ambiguities and Inconsistencies

A variety of other classification ambiguities and inconsistencies arise with respect to each of the following: (1) installment purchases and sales of inventory; (2) sales-type lease receivables; (3) installment purchases and sales of plant assets; (4) purchase and sale of rental assets; (5) casualty insurance settlements; (6) capitalized software development costs; (7) capitalized film development costs; (8) company-owned life insurance; (9) acquisitions and dispositions of businesses; (10) overdrafts; (11) cash equivalents; (12) notes payable; (13) payments to settle pension liabilities; (14) sales and transfers receivables; (15) sale-leaseback transactions; (16) repurchase/reverse repurchase

[75] See also section *Analytical Adjustments — Prospective Income Tax Effects.*

agreements; and (17) hedging transactions. Each of these items is discussed in succeeding sections of this paper.

E.1. Installment Sales and Purchases of Inventory

In developing SFAS-95, the FASB (SFAS-95, ¶ 93) notes a classification ambiguity with respect to installment sales and purchases of inventory when the cash flows occur over several years. The FASB suggests that installment sales could be viewed as having aspects of both an operating transaction for the selling activity and an investing transaction for the long-term credit extended to the customer. Similarly, installment purchases could be viewed as having aspects of both an operating transaction for the purchasing activity and a financing transaction for the long-term credit received from the supplier. This dual transaction perspective was proposed in the Exposure Draft (ED, 1986, ¶ 10) to SFAS-95: Only cash flows occurring "soon before or after" the time of sale or purchase would have been classified as operating inflows or outflows. Subsequent principal collections or payments on the related notes would have been investing inflows or financing cash outflows, respectively; similarly, subsequent interest collections or payments on the related notes would have been operating inflows or outflows, respectively.

Under this dual transaction perspective, cumulative NCFO over the life of a company that sells principally on the installment basis might be negative, a potentially inappropriate and confusing result. As a result, SFAS-95 (¶ 94) notes that "[s]ome respondents to the Exposure Draft suggested that cash inflows and outflows from installment sales and installment purchases should be classified consistent with the original purpose for which received or paid." Under this view, which is prescribed in SFAS-95 (¶ 95), all cash collected from customers or paid to suppliers from the sale or purchase of inventory should be classified as operating cash flows regardless of when collected or paid. SFAS-95 (ibid.) notes that this classification is consistent with the notion that NCFO generally includes items that are included in net income. It is also consistent with the stated objective of the cash flow statement to report just actual cash flows, which is essentially a single transaction perspective. However, three FASB members dissented to SFAS-95 in part because they concluded (see SFAS-95, pp. 10-11) that classifying principal collections on customer installment receivables as operating inflows is inconsistent with classifying principal collections on investments in debt securities as investing inflows; and that classifying principal payments on supplier installment payables as operating outflows is inconsistent with classifying principal payments on other debt as financing outflows.

Mulford & Comiskey (2005, pp. 105-106) note that Motorola, Qualcomm, and Lucent Technologies, Inc. report changes in long-term customer receivables balances in the reconciliation of

net income and NCFO, consistent with SFAS-95. Increases in the receivables balances reduce NCFO, whereas decreases in the balance increase NCFO. On the other hand, Nortel Networks Corp. and Harley-Davidson, Inc. provide similar financing to its customers in the form of long-term receivables, but report increases in these receivable balances in deriving NCFI, thereby boosting reported NCFO. Mulford & Comiskey (2005, p. 106) note, for example, that had Nortel included increases in its long-term receivables in the reconciliation to derive NCFO, the reported decrease NCFO in 2001 and 2002 would have much worse than reported.[76]

Mulford & Comiskey (2005, pp. 106-107) also note that Harley-Davidson, Inc., follows a similar approach to Nortel. Harley's finance subsidiary, Harley-Davidson Financial Services, Inc., provides wholesale financing of dealer inventory, and retail financing for customer purchases from its dealer:

> All of Harley's finance receivables, wholesale and retail, are reported in the investing section of the cash flow statement. For the retail accounts, an investing classification would appear to be appropriate because these are not receivables from Harley's customers but rather the customers of Harley's customers, that is, the retail purchasers. Harley invests its cash flow in these receivables. However, an operating designation would appear to be more appropriate for the finance receivables from Harley's customers the dealers.

They (2005, p. 107) note that Harley reported NCFO of $779.5 for 2002, up from $756.8 million in 2001; had Harley adjusted NCFO rather than NCFI for the change in its wholesale receivables, NCFO would have declined to $639.9 in 2002 from $645.4 million in 2001.

More recently, the SEC (2005) concluded that reporting cash flows between a registrant and its consolidated subsidiaries as an investing cash outflow and an operating cash inflow when there has not been a cash inflow to the registrant on a consolidated basis from the sale of inventory is not in accordance with GAAP. Similarly, reporting cash receipts from receivables generated by the sale of inventory as investing activities in the registrant's consolidated statements of cash flows is not in accordance with GAAP.[77]

[76] This reflects the previously mentioned defect of indirect method, the absence of an external referent to NCFO. By adding the increase in long-term receivables to derive NCFI rather than NCFO, the subtotals in the cash flow statement sum to the change in cash, but with offsetting errors.

[77] The SEC (2005) requires that registrants disclose where the cash flows related to the sale of inventory are classified in the consolidated cash flow statement and explain the nature of the receivables/notes/loans and where the cash flows from these transactions are classified in the consolidated cash flow statement. It also requires consistency between the line item descriptors in the consolidated cash flow statements and those in the consolidated balance sheet and financial statement footnotes detailing the components of finance receivables.

Under SFAS-95, a stated objective of the cash flow statement is to report actual cash flows, not hypothetical "as-if" cash flows, as noted previously. Additionally, SFAS-95 does not distinguish between non-financial and financial companies. Implicitly, however, the discussion in SFAS-95 on installment sales and purchases presupposes non-financial companies, not financial companies, as will the remaining part of this section.

From a finance perspective, when installment sales are routine, an ostensibly non-financial company becomes a non-financial company with a financial component lending to its customers.[78] Accordingly, within the context of the stated objectives of SFAS-95 of reporting just actual cash flows, the classification issue of a non-financial company is whether routine installment sales should be viewed as both operating transactions for the down payment and investing transactions for the loan to the customer. Similarly, the classification issue of a non-financial company is whether routine installment purchases should be viewed as both operating transactions for the down payment and financing transactions for the loan from the supplier.

This dual transaction perspective to distinguish between the operating and investing aspects of routine installment sales impairs the distinction between operating and investing inflows in deriving NCFO and NCFI. Similarly, a dual transaction perspective to distinguish between the operating and financing aspects of routine installment purchases impairs the distinction between operating and financing outflows in deriving NCFO and NCFF. For both, SFAS-95 got it right within its stated objective of reporting just actual cash flows under a single transaction perspective: All principal collections from customers and principal payments to suppliers relating to routine sales or purchases of inventories should be classified as operating cash flows regardless of when collected or paid. Otherwise, reported NCFO would be meaningless for non-financial companies with mainly installment sales or purchases of inventories: For installment sellers, cumulative NCFO over the life of a company might be negative, a potentially inappropriate and confusing result; for installment buyers, cumulative

[78] From a finance perspective, one might argue that non-business related lending activities of non-financial companies are negative financing activities, not investing activities as under SFAS-95. Accordingly, one might argue that for an occasional (as opposed to routine) installment sale of inventory by a non-financial company, the classification issue is whether the cash flows are operating flows for the down payment at the time of sale and a negative financing (not investing) flow for the lending to the customer. Similarly, one might argue that for an occasional installment purchase of inventory by a non-financial company, the classification issue is whether the cash flows are operating flows for the down payment at the time of purchase and financing flows for the borrowing from the supplier. As a practical matter, it is not useful to distinguish between occasional versus routine installment sales and purchases of inventories for cash flow reporting purposes. The cash flow statement trichotomy is complicated enough without this distinction. So the same classification rules should apply to occasional and routine installment sales and purchases for cash flow reporting purposes. And it makes more sense for the trichotomy to be based on routine rather than occasional installment sales and purchases.

NCFO over the life of a company might be abnormally high, another potentially inappropriate and confusing result.

Recall that from a finance perspective, when non-financial companies acquire non-trading debt securities to secure some business relationship or provide customers with credit, they are investing activities, not negative financing activities; and interest collections thereon are operating inflows, not financing inflows. Making intermediate- or long-term installment loans to customers is similar to acquiring their debt securities; both are investing activities, not negative financing activities. Accordingly, interest collections on installment loans to customers should be reported as operating inflows consistent with SFAS-95, not financing inflows.[79] However, contrary to SFAS-95, interest payments on installment payables to suppliers should be reported as financing outflows by non-financial companies, consistent with the classification of other interest payments by non-financial companies.[80]

From a finance perspective, however, a more meaningful analysis (but not financial reporting) of cash flows would not involve a one-or-the-other classification of such installment principal collections or payments as either an operating or investing flows. Rather, a more meaningful analysis would involve hypothecating cash inflows and outflows so that the seller's adjusted cash flow statement includes operating inflows for installment sales, and investing outflows and inflows, respectively, for lending and collecting the installment loan principal. Similarly, from a finance perspective, a more meaningful analysis would involve hypothecating cash inflows and outflows so that the buyer's adjusted cash flow statement includes operating outflows for installment purchases, and financing inflows and outflows, respectively, for borrowing and repaying the installment loan principal. But this more meaningful analysis involves hypothecating cash inflows and outflows, hence is contrary to the stated objective of SFAS-95 to report just actual cash flows. It is recommended, however, for analytical purposes.[81]

E.2. Sales-Type Lease Receivables

Lease receivables arising from sales-type leases are similar to receivables from installment sales; indeed, sometimes the only difference is that the contract is called a lease rather than an installment

[79] See Section VIII C, *Purchases, Sales and Interest Collections on Non-trading Debt Securities.*

[80] Conceivably, from a financial perspective, the non-financial component could report installment sales as operating inflows from the financial component; and the financial component could report installment sales as investing outflows and inflows, respectively, for lending and collecting the installment loan principal. Although there is some merit to this viewpoint, it does not reflect the cash flows of the overall company with external parties, and is explicitly rejected by the SEC, as noted previously.

[81] See also Section X B, *Analytical Adjustments of the Cash Flow Statement — Non-cash Transactions.*

sale. At least for non-financial companies, both have aspects of an operating transaction for the selling activity and an investing transaction for the long-term credit extended to the customer. Under SFAS-95, however, this dual transaction perspective is rejected, and properly so, as noted previously. Accordingly, collections of principal on the lease receivable and interest are operating inflows under SFAS-95, and changes in the lease receivable should be included in the reconciliation of net income and NCFO, not in investing activities. (The distinction is not too important if FCF supplants NCFO as the key cash flow statement number for assessing firm value.)

However, Mulford & Comiskey (2005, p. 107) report that some companies classify increases in sales-type lease receivables as investing activities, presumably to boost reported NCFO but contrary to SFAS-95. Implicitly, these companies view sales-type lease receivables as long-term customer loans to be reported as investing activities under SFAS-95. For example, they (ibid.) note that Cisco Systems Corp. classifies changes in sales-type lease receivables in investing activities, contrary to SFAS-95. On the other hand, they (ibid.) note that Xerox Corp. sells equipment to its customers on the installment basis and also through sales-type lease arrangements; Xerox reports changes in both receivables in the reconciliation of net income and NCFO, consistent with SFAS-95.

In many respects, sales-type leases are more similar to than different from installment sales of inventories, and should be reported similarly in the cash flow statement. Accordingly, within the SFAS-95 context of reporting just actual cash flows, non-financial companies should classify all principal collections from sales-type leases as operating cash flows regardless of when collected. Otherwise, reported NCFO would be meaningless for non-financial companies that structure most sales as sales-type leases. Additionally, interest collections on sales-type leases should be reported as operating inflows by non-financial companies, consistent with the classification of interest collections on intermediate- or long-term installment loans to customers as operating inflows.

Like installment sales of inventory, however, a more meaningful analysis (but not financial reporting) of cash flows from sales-type leases would involve hypothecating cash inflows and outflows so that the seller's adjusted cash flow statement includes operating inflows for sales-type leases; and investing outflows and inflows, respectively, for lending and collecting principal. But this more meaningful analysis involves hypothecating cash inflows and outflows, hence is contrary to the stated objective of SFAS-95 to report just actual cash flows. It is recommended, however, for analytical purposes.

E.3. Installment Purchases and Sales of Plant Assets

Under SFAS-95 (¶ 96), for installment purchases of plant assets, only early payments of principal, such as advance payments and down payments, are investing cash outflows; subsequent payments of principal are financing outflows.[82] The FASB concluded (SFAS-95, ¶ 96) that it would be unduly burdensome to separate installment payments to sellers of plant assets, which otherwise would be investing outflows, from installment payments to third-party creditors, which are financing outflows, over the generally long payment period. Rather, SFAS-95 (ibid.) classifies both types of installment payments as financing outflows.

The treatment of the principal portion of installment payments for plant assets as financing outflows results in an incomplete reporting of investing outflows for such purchases. It is also inconsistent with the cash flow reporting of installment sales of plant assets. Under SFAS-95 (¶ 16(c)), for installment sales of plant assets, all receipts of principal are investing inflows, not just the early receipts, resulting in a complete reporting of investing inflows from such sales. Of course, both treatments result is a more favorable calculation of FCF than would be forthcoming if installment principal payments were classified as investing outflows and the installment principal collections were (for whatever reason) not classified as investing inflows. It also may induce corporate management to structure plant asset acquisitions as installment purchases to boost FCF. The favorable effect on FCF may explain why few accountants are disturbed by this long-recognized inconsistency in SFAS-95.

This writer questions how burdensome it is with computerized accounting information systems to separate installment payments to sellers of plant assets from installment payments to third-party creditors. The burdensome rationale is even more questionable now in 2006 than in 1987 when SFAS-95 was issued, given the advances in computerized accounting information systems over this nineteen year span. On the basis of accounting theory, it is a poor justification for an incomplete cash flow reporting of installment purchases of plant assets. It is also a poor justification for the inconsistent cash flow reporting of installment purchases and sales of plant assets. In theory, barring measurement and

[82] Additionally, advance payments and down payments are not defined unambiguously by SFAS-95. As an example, for assets acquired by lessees under capitalized leases, the early lease payments are comparable to down payments in purchase-borrow transactions, and should be classified as investing outflows. But SFAS-95 implies that all payments under capital leases are for interest and principal and should be classified as operating and financing outflows, respectively. Accordingly, most lessees appear to classify early lease payments under capitalized leases as financing outflows, not investing outflows, even if the lease payments are made at the inception of the lease and are virtually equivalent to down payments. The result is an improvement in FCF. In many respects, capital leases of plant assets are more similar to than different from installment purchases of plant assets. Accordingly, if the FASB elects to retain the SFAS-95 treatment of installment purchases of plant assets, it should amend SFAS-95 to unambiguously define early lease payments as down payments, hence as investing outflows, not financing outflows.

recognition (valuation) problems, the financial reporting of sales and purchases should be the mirror image of one another.

More important, the incomplete reporting of investing outflows by classifying the installment principal payments as financing outflows undermines the representational faithfulness and comparability of NCFI and FCF when installment purchases of plant assets are material. Accordingly, the FASB should amend SFAS-95 so that all principal payments on installment purchases of plant assets are reported as investing outflows, not just the early payments, consistent with classifying all principal receipts on installment sales as investing inflows, not just the early receipts.

However, from a finance perspective, a still more meaningful analysis (but not financial reporting) of cash flows from installment purchases of plant assets would involve hypothecating cash inflows and outflows so that an adjusted cash flow statement includes investing outflows for the equivalent cash purchase price, financing inflows for the borrowing, and financing outflows for the principal payments. But this more meaningful analysis involves hypothecating cash inflows and outflows, hence is contrary to the stated objective of SFAS-95 of reporting just actual cash flows. It is recommended, however, for analytical purposes.

E.4. Purchase and Sale of Rental Assets

The presence of company-owned rental assets creates another classification issue in cash flow reporting because the related cash flows may not be clearly derived from either operating or investing activities. The classification affects NCFO but not FCF. Under SFAS-95, the acquisition and sale of inventories are operating activities, whereas the acquisition and sale of productive assets to be used by the entity or rented to others are investing activities. However, productive assets are sometimes acquired and used or rented to others for a short time before being sold. Examples include automobiles of automobile rental companies, real estate of real estate development companies, and various merchandise of rent-to-own companies. Because rental assets could be viewed either as inventory or plant assets, similar rental companies may classify outlays for rental assets as operating or investing outflows, without disclosing the reason for the chosen classification.

For example, Hertz Corporation reports Revenue Earning Equipment (REEQ) in an unclassified balance sheet after Inventories and Prepaid Expenses and before Property and Equipment. For 1991, REEQ turns over approximately twice a year[83] and represents 58 percent of total assets, whereas car rentals are 75 percent of total revenue. The rapid turnover makes REEQ acquisitions and

sales appear to be operating activities, almost like inventory. But car rental revenues are Hertz's revenue source, hence REEQ acquisitions and sales also appear to be investing activities. According to SFAS-95 (¶ 22(a)), "the appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows." The fact that car rental revenues are Hertz's principal revenue source of Hertz's supports classifying REEQ acquisitions and sales as investing activities rather than as operating activities. Hertz reports the $231.64 million net cash outlay on REEQ in 1991 ($4.016 billion for acquisitions less $3.784 billion from disposals) as operating activities. The classification has a material effect on reported operating and investing net cash flow subtotals. Reclassifying Hertz's $231.64 million REEQ net cash outflow as investing activities increases net operating cash inflow by 81 percent and increases net investing outflow by 320 percent.

In contrast, Agency Rent-A-Car reports cash flows from acquisitions and sales of Rental Automobiles (RA) as investing activities. It also provides an unclassified balance sheet, with RA reported under Property and Equipment and amounting to at least 49 percent of total assets in 1994;[84] car rentals are 77 percent of total revenue. Net cash received on RA transactions of $5.751 million ($68.96 million realized on sales less $63.21 million spent on purchases) is highly material to Agency's net $9.06 million investing cash outflow, less so to the $83.15 million reported NCFO. Agency's rental fleet turns over more slowly than Hertz's, about every other year. The predominance of rental revenues and low RA turnover supports investing activity classification. Again, the classification has a material effect on reported NCFO and NCFI. Reclassifying Agency's $5.75 million RA net cash inflow from investing to operating increases its net investing outflow by 63 percent while increasing NCFO by 7 percent.

Similarly, Mulford & Comiskey (2005, p. 90) note that there is little difference between merchandise held for sale or lease and merchandise available for installment sale; in substance, a rent-to-own agreement might be viewed as an installment sales contract. Nevertheless, they (ibid.) note variation in cash flow statement classification by companies in the rent-to-own industry. For example, they (ibid.) note that outlays for rent-to-own merchandise were classified by Aaron Rents, Inc. as investing outflows through 2002 but as operating outflows starting in 2003. On the other hand, Bestway, Inc. continues to classify outlays for rent-to-own merchandise as investing outflows.

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[83] Turnover of the rental fleet is estimated by dividing current year acquisition payments by the average of the beginning and ending net book value of the rental fleet. For Hertz, 1991 payments for REEQ of $4.016 billion divided by $2.336 billion average net book value implies an approximate turnover of 1.72 times per year, or about every seven months.

[84] Because Agency Rent-A-Car subtracts accumulated depreciation from the total of RA, dealership inventory, and other property and equipment, the net book value of RA cannot be calculated precisely. The 49 percent reflects the conservative assumption that all accumulated depreciation pertains to RA.

The appropriate classification of cash flows from rental assets depends on the activity most likely to be the predominant source of cash flows for the item. When productive assets are themselves direct sources of revenues, such as inventory-like assets rented for a short period and then sold, their acquisition and subsequent sale are operating activities, not investing activities. Ernst & Whinney (1988, 10) suggests that cash flow statement classification should be consistent with balance sheet classification of the related assets. Implementing this suggestion achieves consistency across financial statements, but may not enhance comparability across reporting entities.

Moreover, the predominant source of cash flows and therefore the primary activity is not always clear cut. For example, consider an automobile rental company that turns over its fleet once or twice a year. Is it primarily in the business of renting automobiles, or is it primarily in the business of buying and selling automobiles? Similarly, is a real estate development company that rents and then sells properties primarily in the business of renting real estate, or is it primarily in the business of buying and selling real estate?

For both types of entities, when the predominant source of cash is from rentals, rental asset acquisitions and sales are investing activities. When the predominant source of cash is from buying and selling, rental asset acquisitions and sales are operating activities. But what if the predominant source of cash is from renting in some years and from buying and selling in other years? What are the implications of such changes for balance sheet and cash flow statement classification purposes?

Because facts and circumstances change over time within a company and differ across companies, the problem of interperiod and intercompany comparability of rental asset cash flows is something standard setters cannot easily resolve. But additional disclosures can help users assess whether some "rental" companies are dealers (operating) or non-dealers (investing). Disclosing rental asset gross cash flows, turnover ratios, and classification policies for rental asset acquisitions and disposals enhances the fineness of the cash flow statement. Of course, the issue is obviated if FCF supplants NCFO as the key cash flow statement number for assessing firm performance and firm value.

E.5. Casualty Insurance Settlements

SFAS-95 (¶ 16(c)) notes that receipts from sales of plant assets are investing inflows; it (¶ 22(c)) notes, however, that "[a]ll other cash receipts that do not stem from transactions [that it] defined as investing or financial activities are operating inflows," the residual category. One interpretation of SFAS-95 would be to classify proceeds from insurance settlements incident to the destruction of inventory as operating inflows, and proceeds incident to the destruction of plant assets as investing inflows, as if

each type of asset was sold to the insurance company. For example, American Media reported insurance proceeds received to replace an asbestos contaminated building as an investing inflow in 2003.

However, because SFAS-95 does not unambiguously define insurance proceeds incident to the destruction of plant assets as investing inflows, one might argue that such proceeds are operating inflows, the residual category. Perhaps for this reason, Mulford & Comiskey (2005, p. 108) note that many companies report similar insurance settlements for damaged or destroyed plant assets as operating inflows. They (ibid.) cite Gulfport Energy Corp., which incurred significant damages from Hurricane Lilli. For 2003, Gulfport reported $2.5 million of insurance proceeds to reimburse it for the damages to production facilities and an oil field as an operating inflow included in its $6.5 million reported NCFO; but it reported $0.558 million cash paid to replace the facilities as an investing outflow. As reported, the net effect of the hurricane was to boost reported NCFO offset with an increase in investing outflows. Mulford & Comiskey (ibid.) conclude that "[a]n investing classification for the insurance proceeds received for the replacement of destroyed equipment would appear to have been more appropriate [under SFAS-95]." The classification affects reported NCFO but not FCF broadly defined to include investing inflows.

Other companies classify casualty insurance proceeds for damage to plant assets as operating inflows, consistent with the view that the proceeds are not for the damage per se but for the cost of continuing to operate despite the interruption due to the damage. For example, Rapoport (2005) reports that Network Equipment Technologies used this rationale in reporting a $23.7 million operating inflow for insurance proceeds from a claim for groundwater damage that forced the company to vacate a leased building. This classification resulted in a substantial improvement in reported NCFO. Rapoport cites Mulford as acknowledging that a fine line exists under SFAS-95 as to whether insurance proceeds stem from investing activities (like damage to plant assets) or from operating activities (like the costs of staying open after a disaster); to Mulford, however, the Network Equipment Technologies' proceeds appear to be on the investing side of that line.

This writer concurs with Mulford & Comiskey: Proceeds from insurance settlements incident to the destruction of plant assets owned or leased (under capital leases) are more like investing inflows than like operating inflows, both under SFAS-95 and from a finance perspective. Treating such proceeds as investing inflows, as if the plant assets were sold to the insurance company, seems appropriate for plant assets; treating the proceeds as operating inflows seems inappropriate, as operating inflows arise principally from transactions with customers, not insurance companies. And

arguing that the proceeds are operating inflows because the casualty precludes using plant assets in operations seems irrelevant if not disingenuous; the proceeds result from damage or destruction of plant assets, not from lost business. However, proceeds from business interruption insurance are appropriately classified as operating inflows.

The SEC seems to concur with Mulford & Comiskey and me. In December 2005, the Associate Chief Accountant of the SEC's Division of Corporation Finance (see Levine, 2005) suggested that proceeds from insurance settlements should be classified based on the nature of the loss covered by the insurance policy, not by how the insured spends or plans to spend the proceeds: Classification of proceeds received under a policy that protects against property damage or loss depends on the nature of the property. Proceeds for loss of plant assets owned or leased under capital leases are investing inflows; proceeds for loss of inventories and plant assets under operating leases are operating inflows, as are proceeds under a business interruption policy.[85]

E.6. Capitalized Software Development Cost

Under SFAS-95 the cash flow statement classification of outlays for software development cost depends on whether they are expensed as incurred or capitalized as assets. If expensed, they are classified as operating outflows; if capitalized, they are classified as investing outflows. When total outlays differ from total costs, there are several ways to allocate outlays between capitalized and uncapitalized software development cost, much as there are several ways to allocate interest payments between capitalized and uncapitalized interest cost. The distinction is important for purposes of deriving NCFO but not FCF.

Mulford & Comiskey (2005, p. 98) note that due to GAAP flexibility and management judgment, capitalization practices vary significantly across companies that develop software for sale. They cite a survey of firms by Ely and Waymire (2003): in 1998, 175 firms expense all software development costs, whereas 167 firms capitalized at least some portion, averaging 26 percent. Mulford & Comiskey (2005, p. 99) also note that most companies report outlays for capitalized software development costs as investing outflows, e.g., A.D.A.M, Inc. for 2002, but occasionally as operating outflows, e.g., Activision, Inc., for 2001-2003.

The varied classification of outlays for software development costs in the cash flow statement harkens back to Penman's (2007, p. 359) argument that NCFO as defined by SFAS-95 is really an

[85] Additionally, he (Levine, 2005) noted that material cash settlements should be discussed in the MD&A so investors can understand what was received, why it was received, what the company plans to do with it, how it's been presented in the cash flow statement, and the impact on reported earnings.

accrual concept; that the distinction here between operating and investing outflows depends on distinguishing between software development costs that are expensed versus those that are capitalized; but that distinguishing between the two is less important because FCF rather than NCFO should be the key number for assessing firm value. However, concurring with this viewpoint need not preclude distinguishing between operating and investing activities in order to report NCFO as an alternative performance metric to assess the cash flow versus accrual components of net income. Accordingly, cash flow statements should continue to distinguish among operating, investing, and financing activities, rather than just between investing and financing activities. Because capitalized software development costs generate benefits over an extended period, they are intangible assets. They should be classified as investing outflows in the cash flow statement, like outlays for other intangible assets. However, GAAP should be revised to make more uniform the criteria for reporting software development costs as assets in the balance sheet and the related outlays as investing outflows in the cash flow statement.

E.7. Capitalized Film Development Costs

Mulford & Comiskey (2005, p. 100) note that because capitalized film development costs generate benefits over an extended period, one would expect them to be classified as investing outflows in the cash flow statement under SFAS-95. However, under AICPA Statement of Position 00-2, *Accounting by Producers or Distributors of Films* (AICPA SOP 00-2, 2000, ¶ 55), capitalized film production costs are classified as operating outflows in the cash flow statement. For example, Mulford & Comiskey (2005, p. 101) note that Metro-Goldwyn-Mayer, Inc., reports negative $88.779 million NCFO for 2002, including a $468.083 million operating outflow for capitalized film production costs. They (ibid.) also note that "[c]onsistent with GAAP, other motion picture studios also report capitalized film production costs as operating outflows. Included are such firms as Pixar and Fox Entertainment Group, Inc., as well as smaller firms including Film Roman, Inc., and Lions Gate Entertainment Corp. Again, the distinction is important for purposes of deriving NCFO but not FCF.

Mulford & Comiskey (2005, p. 102) contrast the cash flow statement classifications of capitalized film production costs with software development costs. For both, costs are incurred to acquire long-lived assets, and these costs are capitalized and amortized over the future periods benefited, similar to plant assets, for balance sheet and income statement reporting purposes. Somewhat inconsistently, however, plant asset costs and capitalized software development costs are classified as investing outflows, whereas film development costs are classified as operating outflows.

They (ibid.) note that users must be aware of these diverse industry practices to understand exactly what is included in NCFO. However, the distinction does not affect FCF.

Because capitalized film development costs generate benefits over an extended period, they are intangible assets. Accordingly, they should be classified as investing outflows in the cash flow statement, like outlays for other intangible assets. They do not fit the definition of an operating outflow under SFAS-95. For this reason, SOP 00-2 should be amended.

E.8. Company-Owned Life Insurance

Starting in the 1980s, many companies began to take out life insurance policies on many if not most of their employees, including low-level managers, clerks, and janitors, often without employee notification or consent. Because the companies are the policyholders and beneficiaries, the policies are called "company-owned life insurance" (COLI).

Classification of Annual Premiums

Nurnberg (2004, pp. 112-113) notes that there are at least two ways of classifying the annual COLI premium payment under SFAS-95. Under the operating approach, the annual COLI premium payment is an operating outflow for insurance expense and cash surrender value (CSV). Implicitly, the CSV is considered an operating asset akin to inventory. This classification presupposes that COLI is used to reduce overall employment and/or postretirement costs, hence is an integral aspect of operating activities. Under the operating-investing approach, the COLI annual premium payment represents an operating outflow for insurance expense and an investing outflow for the build up of CSV. This cash flow statement classification is consistent with viewing the CSV as a non-operating asset akin to an investment. It also presupposes that COLI is a combination of operating and investing activities. The classification is important for purposes of deriving NCFO but not FCF.

Because the operating approach classifies the entire COLI premium payment as an operating outflow, it is simpler to apply than the operating-investing approach. However, it results in a greater reduction in reported NCFO due to the premium payment. Perhaps for this reason, most companies appear to use the operating-investing approach.

Classification of Death Benefits

Nurnberg (2004, p. 113) identifies four alternative ways to classify the COLI death benefit proceeds inflow under SFAS-95:

- **Method A:** All proceeds are an operating inflow. This assumes that the CSV is an operating asset, that the “disposal” of the CSV should be treated the same as proceeds from selling inventory.

- **Method B:** All proceeds are an investing inflow. This assumes that the CSV is a non-operating asset, that the "disposal" of the CSV should be treated the same as proceeds from selling an investment.

- **Method C:** The proceeds include an operating inflow for recovering insurance expense and an investing inflow for the balance. Classifying the recovery as an operating inflow is similar to classifying inventory supplier refunds as operating inflows. It also assumes that the CSV is a non-operating asset.

- **Method D:** The proceeds include an investing inflow for recovering the CSV, and an operating inflow for the balance. This is consistent with considering the CSV a non-operating asset.

If the entire COLI premium payment is classified as an operating outflow under the operating approach, the entire death proceeds should be classified as an operating inflow under Method A. Reporting any portion of the death proceeds as an investing inflow under Methods B, C, or D is inconsistent with classifying the entire COLI premium payment as an operating outflow under the operating approach.

Alternatively, if the COLI premium payment is classified partly as an operating outflow and partly an investing outflow under the operating-investing approach, the death benefit proceeds could be classified as an investing inflow under Method B. But it could also be classified partly as an operating inflow and partly as an investing inflow under Methods C or D.

Methods C and D involve splitting cash inflows from death benefits between operating and investing activities. Splitting cash inflows this way is based on "backwards tracing" of the related premium payment outflows between expense and build up of CSV.[86]

COLI Materiality Issues

The cash flow statement classification of COLI flows can significantly impact reported NCFO but is less likely to affect FCF broadly defined. For example, Nurnberg (2004, p. 110) notes that in 2000, Sovereign Bankcorp reports COLI income of $34.324 million, a $200.000 million COLI investment, and negative $188.929 million NCFO. However, its 10-K does not clarify whether there was just one net outflow of $165.676 million or one or more inflows and one or more outflows that net to $165.676

[86] According to Nurnberg (2004, pp. 113-114), some accountants believe that such backwards tracing is unprecedented in the cash flow statement: that the death benefit proceeds should be classified in the cash flow statement based on the preponderance of the activity to which they relate; and that COLI for most companies reflect investing activities consistent with Method B. However, Nurnberg (2004, p. 114) notes that although backwards tracing may be unprecedented in the cash flow statement, it is required under GAAP in the income statement and balance sheet in other circumstances; and that Methods C and D are logically conceivable alternative treatments of the COLI death benefit proceeds and are not explicitly prohibited by SFAS-95.

million. Assuming the latter as more likely, Nurnberg (2004, pp. 117-118) suggests that Sovereign Bankcorp views the CSV as an operating asset for cash flow statement purposes, consistent with the operating approach for premium payments and Method A for COLI death benefits. He (ibid.) estimates that had Sovereign used the operating–investing approach and Method D, negative NCFO would decrease from negative $188.929 million to positive $11.071 million, a 105.86 percent change.

Nurnberg (2004, p. 122) also notes that for 1997, American Business Products, Inc. (ABP) reports a $1.472 million investing outflow for the portion of COLI premium payments that increase COLI net assets, consistent with the operating-investing approach, but includes an estimated $4.135 million of COLI death benefit proceeds in NCFO. Like Sovereign, the amounts of COLI premium payments and COLI death benefit proceeds for 1997 cannot be determined unambiguously from ABP's 10-K. Nurnberg (2004, p. 122) suggests, however, that ABP appears to mix classification methods in a manner that increases reported NCFO. He (ibid.) estimates that had ABP classified all of the $4.135 million death benefit proceeds as an investing inflow consistent with Method B, NCFO for 1997 would decrease from $29.865 million to $25.730 million, or 13.85% less.

Evaluation of COLI Flows under SFAS-95 Trichotomy

SFAS-95 (¶ 21) defines operating activities as a residual category that includes all transactions not defined as investing or financing activities. Because it makes no mention of COLI premium payments or death benefits, one could argue that all COLI cash flows are operating flows under SFAS-95. Accordingly, the operating approach for COLI premium payments and Method A for COLI death benefits are fully consistent with SFAS-95.

SFAS-95 (¶ 21) also notes that the cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income. Consistent with this inclusion concept, COLI premium payments that are expensed and COLI death benefit proceeds that are reported as income could be classified as operating flows. However, COLI premium payments that are capitalized as CSV and COLI death benefit proceeds that are a recovery of CSV could be classified as operating or investing flows, depending on whether the CSV is an operating or non-operating asset. Unfortunately, no definition of the term operating or operations is universally applicable to all firms under GAAP.

However, employing a workforce is a central operating activity of virtually all non-financial and financial companies; operations usually depend on maintaining a workforce. If one views COLI as a hedge against the premature loss of key employees or just as employment-related, then the resulting

cash flows could be classified as operating (under the operating approach and Method A). Alternatively, if one views COLI as a tax preferred investment, then COLI premium payments should be allocated between operating and investing outflows (under the operating-investing approach), and COLI death benefits should be classified as investing inflows (under Method B) or allocated between operating and investing inflows (under Methods C or D) by both non-financial and financial companies.[87] The distinction is important for purposes of deriving NCFO but does not affect FCF broadly defined.

E.9. Acquisitions and Dispositions of Businesses

Under SFAS-95 (¶ 132-135, pp. 44-51, esp. ¶ 134[g]), a company reports as a single investing outflow the cash paid to purchase a business (net of any cash acquired), including the portion of the payment attributable to operating receivables and inventories acquired less operating liabilities assumed. Although less precise, SFAS-95 permits a company to report as a single investing inflow the cash received from selling a business (net of any cash transferred), including the portion of the collection attributable to operating receivables and inventories sold less operating liabilities transferred. As a result, reported NCFO may increase directly as a result of business acquisitions (henceforth acquisitions) and business dispositions (henceforth dispositions), although the acquisitions and dispositions themselves are reported in the cash flow statement as investing activities.

Effect on Reported NCFO

Mulford & Comiskey (2005, pp. 113-14) note that when companies make acquisitions, reported NCFO typically receives an unsustainable boost. NCFO for the two companies are combined, but cash flow statements of prior years are not restated, hence are not comparable. Reported NCFO may be boosted further by having the target company slow down operating collections and speed up operating payments from the date negotiated to the closing date. The boost results because cash realizations of net operating assets of the acquired enterprise after acquisition are included in reported NCFO of the combined enterprise under the cash flow statement classification rules.[88]

[87] COLI are inherently long-term investments, not the short-term investments made by non-financial companies to park excess cash. Accordingly, for non-financial companies, acquiring COLI are investing activities, not negative financing activities.

[88] Nurnberg (2006) notes that acquisition and disposition transactions involve substantial costs and, presumably, are rarely entered into solely to manage reported NCFO and FCF. For some companies, therefore, the increases in reported NCFO and FCF are an unanticipated artifact of SFAS-95; for other companies, the increases are anticipated. For still other companies, however, the increases result because management purposely restructures acquisition or disposition transactions to increase NCFO and FCF despite the added costs. Management rarely admits to manipulating NCFO and FCF, however, and it is difficult to document due to a lack of data. An exception is the anecdotal evidence (see Maremont, 2002b) of how one company, Tyco International Ltd., directed acquired companies to prepay operating expenses to lower earnings and cash flow before acquisition closing dates to improve earnings, NCFO, and FCF (narrowly defined) after acquisition.

Additionally, reported NCFO increases further by the cash realized on net operating assets acquired in acquisitions. The potential distortion of NCFO can be substantial. For example, Mulford & Comiskey (2005, pp. 22, 110) estimate that during 1999 and 2000, AutoNation, Inc., expended $1.2 billion on business acquisitions, which included $500 million for inventory, all of which were classified as investing outflows under SFAS-95; during 2001, AutoNation liquidated a substantial portion of its inventory, reporting that liquidation as a $544.7 million operating inflow. In general, the required disclosures do not make transparent these potentially distorting effects, especially when there are many acquisitions or dispositions, or the disclosures are not timely.

Analogously, reported NCFO increases by the cash payments avoided by transferring net operating liabilities to the buyer in business dispositions. By transferring net operating liabilities to the buyer, the seller presumably accepts a lower selling price but avoids payments of these liabilities that would otherwise be classified as operating outflows. The favorable effect of transferring net operating liabilities in dispositions on reported NCFO may be substantial. For example, Nurnberg (2006) estimates that Orbital Sciences reduces negative NCFO for 2001 from $98.52 million to $80.99 million or 17.80 percent, by transferring net operating liabilities incident to the disposition of its MacDonald, Dettwiler and Associates subsidiary.

Effect on FCF

FCF may also increase directly as a result of acquisitions and dispositions, depending on how FCF is defined. FCF always includes collections of net operating assets acquired in business acquisitions, but may or may not include the outflows for the acquisitions themselves. Obviously, the overall impact on FCF over time is more favorable when FCF is defined as NCFO less capital expenditures for plant and other productive assets but not outlays for business acquisitions; the overall impact on FCF is less favorable when FCF is defined more broadly as NCFO less all investing outflows. Similarly, when FCF is defined broadly to include all investing inflows and outflows, total FCF over time is not impacted by transferring net operating liabilities to the to the buyer in a disposition; the reduction in the investing inflow for the proceeds from the disposition offsets the reduction in operating payments in calculating FCF. When FCF is defined more narrowly to exclude inflows from dispositions, FCF over time is favorably impacted by transferring net operating liabilities to the buyer; the avoidance of operating payments by transferring operating liabilities increases NCFO and FCF.

Estimating Impact

Excluding the effects of non-operating transactions and foreign currency exchange rate fluctuations, analysts could estimate the amount of operating receivables and inventories less operating payables acquired in an acquisition as the difference between the change in these accounts in a comparative balance sheet and the amount reported in the reconciliation of net income and NCFO.[89] When a company has several acquisitions and/or both acquisitions and dispositions, the estimate would be for all acquisitions net of all dispositions. But the estimate assumes that balance sheet changes in these accounts are not contaminated by non-operating transactions and significant foreign currency exchange rate fluctuations, not always a reasonable assumption. Sometimes, the effect of non-operating transactions and foreign currency exchange rate fluctuations on these accounts is significant, but is rarely disclosed.

Mulford & Comiskey (2005, p. 113) suggest that "[c]areful scrutiny of the cash flow statement of a target…in the years and quarters leading up to an acquisition should help to isolate any boost to reported NCFO of the combined entity," but such information is only available for publicly owned targets, and often is out-of-date. They (ibid.) note that an unexpected decrease in the NCFO of a target just prior to acquisition may indicate that NCFO has been shifted to the combined entity. They (ibid.) also note that reporting pro forma NCFO would be especially helpful assuming an acquisition had been in effect for all years presented: "Analysts then would be in a better position to compare current year operating cash flow for the combined entity with that of prior years."

Nurnberg (2006) suggests that users would benefit from disclosure of cash inflows from subsequent realization of operating assets acquired and cash outflows from subsequent settlement of operating liabilities assumed in acquisitions; and that users would also benefit from disclosure by major category of operating assets acquired and operating liabilities assumed in acquisitions, and operating assets sold and operating liabilities transferred in dispositions.

E.10. Overdrafts

An increase (decrease) in bank overdrafts represents an increase (decrease) in bank borrowing, and should be classified as a financing inflow (outflow) in the indirect method cash flow statement reconciliation under the SFAS-95 trichotomy. Because it is a borrowing, overdrafts are also a financing activity from a finance perspective. For bookkeeping convenience, however, some companies record an increase (decrease) in bank overdrafts as an increase (decrease) in accounts payable, and then adjust

[89] To estimate the amount of receivables acquired in an acquisition, the difference between the change in receivables reflected in the comparative balance sheet and the amount reported in the reconciliation would also have to be adjusted for any bad debts expense addback adjustment in the reconciliation. See Nurnberg (1996).

net income by the change in accounts payable to derive NCFO under the indirect method without excluding the effect of changes in bank overdrafts. The result is to improperly increase (decrease) NCFO and FCF with an equal and offsetting decrease (increase) in NCFF.

For example, Mulford & Comiskey (2005, p. 136) note that overdraft financing boosted reported 2002 NCFO by $4.17 million or 2 percent for Airborne, Inc., and by $2.09 million, or 5 percent for Strategic Distribution, Inc. On the other hand, they (ibid.) note that overdrafts also can reduce NCFO when overdraft balances decline. For example, overdrafts at Perini Corp. declined by $2.63 million in 2002, thereby reducing reported NCFO. During 2002, Perini reported a negative NCFO of $3.63 million. Had it not been for a $2.63 million decrease in overdrafts, Perini Corp. would have reported negative NCFO of $1.01 million, or $2.63 million less than the $3.63 million amount reported.

Mulford & Comiskey (2005, pp. 136-37) note a still more dramatic example of the effects of overdrafts on reported NCFO. Aviall, Inc. reported a positive $7.7 million NCFO for 2000, including a $15.2 million increase in overdrafts for that year. Had Aviall included the $15.2 overdraft increase as a financing inflow rather than as an operating cash inflow, it would have reported a negative $7.5 million NCFO (i.e., $7.7 million - $15.2 million).[90]

E.11. Cash Equivalents

SFAS-95 (¶ 8) defines cash equivalents as short-term, highly liquid investments that are readily convertible into known amounts of cash and so near maturity that they involve negligible risk of value changes due to interest rate fluctuations. By short-term, SFAS-95 means original maturities to investors of three months or less. Examples include treasury bills, commercial paper, money market funds, and federal funds. A five year treasury note qualifies as a cash equivalent if acquired by the investor within three months of maturity. However, a five year treasury note acquired at issuance or more than three months before maturity does not qualify as a cash equivalent three months before it matures. By definition, therefore, cash equivalents are short-term debt securities; equity securities do not qualify as cash equivalents because they do not have maturity dates.[91]

[90] In 2001, Aviall reported a negative $93.4 million NCFO, including an outflow for a $12.2 decrease in overdrafts. Starting in 2002, Aviall changed its cash flow statement classification practice and started classifying overdraft changes as financing flows.

[91] IASB-7 (¶ 7) defines cash equivalents more broadly. In particular, it (ibid.) notes that "[e]quity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date." Additionally, IASB-7 (¶ 8) notes that when bank overdrafts are repayable on demand and form an integral part of a company's cash management, they are included as a component of cash and cash equivalents.

SFAS Treatment

SFAS-95 views cash equivalent transactions are part of cash management, implicitly an operating activity, not an investing or financing activity. Under SFAS-95, purchases and sales of cash equivalents are viewed as changing the form in which cash is held. Accordingly, purchases and sales are reported net—i.e., they are not reported at all. For example, assume that a company sold for $60,000 cash equivalents that were acquired at a cost of $57,000. The $3,000 gain functions as interest revenue and results in an increase in cash and cash equivalents. Like interest collections, it is an operating inflow pursuant to SFAS-95 classification rules. Under the direct method, the $3,000 gain is included with other interest collections or reported as a separate operating inflow gain on sale of cash equivalents. Under the indirect method, there is no need for a separate line item in the reconciliation of net income and NCFO, because the $3,000 gain is already included in net income and should not be backed out. SFAS-95 does not require disclosure of cash equivalents acquired or sold at cost, because cash and cash equivalents combined is not affected; disclosure is required, however, of material gains or losses on the sale of cash equivalents.

Ostensibly, SFAS-95 requires that the cash flow statement reconcile to the change during the period in cash and cash equivalents. However, this requirement is flexible, because it (ibid., ¶ 10) permits companies to exclude qualifying investments from being treated as cash equivalents. For example, a bank might include all qualifying securities except those purchased for its trading accounts; and an investment company might exclude all qualifying securities and treat them as investments.[92] Because this flexibility results in differences among companies in the securities treated as cash equivalents, SFAS-95 (¶ 55-56) requires each company to disclose its classification policy for treating items as cash equivalents. Additionally, a change in policy constitutes a change in principle that requires restatement of any cash flow statements of prior periods presented in comparative form (ibid., ¶ 10).

Evaluation

[92] Initially, FASB contemplated according banks considerable flexibility in grossing or netting cash flows (ED, 1986, ¶ 52). Subsequently, it opted to provide more flexibility to non-financial entities (SFAS-95, ¶ 78). The flexibility in permitting entities to not classifying certain qualifying securities as cash equivalents reflected lobbying by banks. For example, banks and other financial institutions commonly carry three-month Treasury bills, commercial paper, and similar short-term financial instruments in their trading and investment accounts, where they are commingled with longer term investments. Those institutions generally contend that purchases and sales of those items are part of their trading or investing activities — not part of their cash management program — and they prefer not to treat those items as cash equivalents in the cash flow statement, which would require segregating them from other items in their trading and investment accounts. The FASB agreed that items that meet the definition of cash equivalents but that are part of a larger pool of investment properly considered investing activities need not be segregated and treated as cash equivalents.

From a finance perspective, one (see, e.g., Penman, 2007, pp. 350-52) might argue that the SFAS-95 treatment of cash equivalents muddies the distinctions among operating, investing, and financing activities; acquisitions and dispositions of cash equivalent securities differ little from acquisitions and dispositions of other short-term financial assets but are treated differently in the cash flow statement. To sharpen the distinctions among operating, investing, and financing activities, one (see, e.g., Penman, 2007, pp. 350-352) might argue cash equivalent transactions should be treated as acquisitions or dispositions of other financial assets. As such, one might extend Penman's argument that the appropriate classification of cash equivalent transactions in the cash flow statement should differ for non-financial versus financial companies:

(a) Non-financial companies acquire (dispose of) cash equivalents when they have an excess (or a shortfall) of cash needed for operating activities, much as they acquire (dispose of) short-term investments in debt securities; these represent investments in financial assets, not operating assets (see Penman, 2007, pp. 350-352). As such, from a finance perspective, acquisitions (dispositions) by non-financial companies of cash equivalents are the opposite of borrowing and repaying amounts borrowed; they should be classified as financing outflows (inflows) by non-financial companies. Consistently, interest collections and any gains or losses on cash equivalent transactions should be netted against interest payments and reported as financing flows by non-financial companies.

(b) Financial companies also acquire (dispose of) cash equivalents much as they acquire (dispose of) other short-term investments in debt securities. But financial companies are in the business of borrowing and investing money. For them, acquiring (disposing) of cash equivalents and other financial assets are investment activities. Accordingly, acquisitions (dispositions) of cash equivalents should be classified as investing outflows (inflows) by financial companies. Consistently, interest collections should be reported as operating inflows of financial companies as under SFAS-95.

Alternatively, one might argue that the SFAS-95 treatment of cash equivalents, like its treatment of trading versus non-trading securities, reflects real-world differences in how different companies manage identical transactions. From a finance perspective, some non-financial and financial companies acquire qualifying cash equivalent debt securities as part of their cash management activities, an operating activity. Other non-financial companies acquire the same qualifying debt securities as a means of parking excess cash, a financing activity.[93] Still other financial companies acquire the same

[93] Admittedly, the potential distinction is not completely unambiguous between (1) acquiring qualifying cash equivalent debt securities as part of cash management activities, an operating activity; and (2) acquiring the same qualifying debt securities as a means of parking excess cash, a financing activity. It gives us something to think about.

qualifying debt securities with the intent to hold them for the short-term to generate an interest yield, an investing activity.

Admittedly, the classification of these qualifying debt securities depends on management intent; and differences in management intent result in different cash flow statement classification of otherwise identical cash flows. But different classifications by different companies of the cash flows from identical security transactions reflect real-world differences in their cash management practices which in turn reflect real-world differences in the economics of different companies. Consistent with this reasoning, it is appropriate to report the cash flows of identical qualifying cash equivalent debt securities security transactions differently for different companies when some companies manage these securities as cash equivalents whereas other companies do not.

E.12. Notes Payable

Under SFAS-95, payments for goods and services are operating outflows, whether they are payments of accounts payable or notes payable to suppliers, whereas payments of notes payable incident to loans negotiated with financial institutions are financing outflows. In practice, however, cash flow statement classification varies on payments of notes payable to lenders that finance the acquisition of goods and services, such as in floor-plan financing arrangements.[94]

Mulford & Comiskey (2005, p. 140) note that United Auto Group, Inc., an auto retailer, reports payments on floor-plan-related notes payable as operating cash flows. They suggest (ibid.) that the likely explanation is that floor-plan financing tends to replace accounts payable financing from suppliers for the purchase of inventory. On the other hand, Mulford & Comiskey (2005, p. 141) note that Liberty Homes, Inc., a modular home manufacturer, also uses floor-plan financing to finance unsold inventory, but classifies payments on floor-plan notes payable as financing cash flows. The result, in years when inventory and floor-plan notes payable are decreasing, is to increase NCFO and FCF of Liberty Homes with an equal and offsetting decrease in NCFF.

Under SFAS-95, the cash flow statement should report actual cash flows, not hypothetical "as-if" cash flows. As a result, under SFAS-95, the form of certain transactions affects what is reported. Principal payments of notes payable to suppliers of goods and services should be reported as operating outflows; principal payments of notes payable to suppliers of plant assets (other than down payments)

[94] Mulford & Comiskey (2005, p. 140) describe a floor-plan financing arrangement as follows: "Under a floor-plan financing arrangement, a dealer…pledges its inventory as collateral for a loan. The loan may come from the manufacturer, or, more often, it may come directly from a financial institution. When a unit is sold from inventory, the floor-plan agreement typically requires that an amount, the release price, attributable to the unit sold must be paid to the lender."

should be reported as financing outflows; and principal payments of notes payable to non-supplier creditors should be reported as financing outflows.

SFAS-95 (¶ 32, 70-74) also explicitly addresses the financial reporting of non-cash investing and financing transactions; it specifies that the cash flow statement should be restricted to reporting actual cash flows, and therefore prohibits reporting non-cash investing and financing transactions therein. But SFAS-95 does not address explicitly the cash flow reporting of non-cash operating transactions, such as inventory purchases financed by third-party creditors. Because third-party creditors are not suppliers, however, it seems clear that principal payments to third-party creditors are financing outflows under SFAS-95, not operating outflows, at least the way SFAS-95 is worded. The result of this narrow focus is that a comparative cash flow statement does not report all of a firm's operating transactions.

As noted below, SFAS-95 (¶ 32, 70-74) requires supplemental disclosure of material non-cash investing and financing transactions. However, as Nurnberg (1993, pp. 69-70) notes, SFAS-95 does not unambiguously specify which non-cash transactions require disclosure and which do not.[95] Additionally, SFAS-95 does not address explicitly whether material non-cash operating transactions should be disclosed. Nevertheless, the spirit if not the letter of SFAS-95 would seem to call for disclosure of material non-cash operating transactions such as third-party financed inventory purchases.

From a finance perspective, a more meaningful analysis (but not financial reporting) of third-party financed inventory purchases would involve hypothecating cash inflows and outflows so that the buyer's adjusted cash flow statement includes operating outflows for inventory purchases, as well as financing inflows and outflows, respectively, for borrowing and repaying third-party loan principal. But this more meaningful analysis involves hypothecating cash inflows and outflows, hence is contrary to the stated objective of SFAS-95 of reporting just actual cash flows. It is recommended, however, for analytical purposes.[96]

However, in December 2005, this presentation was called for by the Associate Chief Accountant of the SEC's Division of Corporation Finance (see Levine, 2005). The SEC reasons that the third-party financing entity effectively acts as the inventory buyer's agent. Accordingly, upon purchase of inventory, the buyer should report the increase in the third-party loan as a financing inflow and corresponding operating outflow for the increase in inventory although there was no actual cash

[95] See Section X B, *Analytical Adjustments — Non-cash Transactions.*
[96] See also Section X B, *Analytical Adjustments — Non-cash Transactions.*

flows; the subsequent repayment of the loan would be reported as a financing outflow, and the subsequent customer collection from the sale of the inventory would be reported as an operating inflow. The SEC (see Levine, 2005) reasons that this accounting will result in the cash flow statement depicting the substance of the transaction, similar to when the buyer finances inventory directly with the inventory supplier, and with a similar net effect on operating cash flows equal the amount of gross profit generated. This presentation is required, at least for publicly owned companies. It results, however, in reporting hypothetical cash flows, an apparent departure from the basic object of SFAS-95 of reporting only actual cash flows.

E.13. Sale or Transfer of Receivables

As noted earlier, cash flows from collecting or selling customer accounts and notes receivables are operating inflows under SFAS-95 whether collected in the short-term or the long-term. Depending on the facts and circumstances, transfers of accounts receivable are reported either as sales or collateralized borrowings under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB, SFAS-140, 2000).[97] Transfers of accounts receivable that are structured as sales are often referred to as securitizations.

If the transfer is a sale, the proceeds are classified as operating inflows; subsequent collections from the customer by the transferor are as an agent and are not reported as cash inflows. On the other hand, if the transfer is a collateralized borrowing, the loan proceeds are classified as financing inflows, and the loan repayments are financing outflows; subsequent collections from the customer by the transferor are operating inflows. Mulford & Comiskey (2005, p. 23, 293) note that the substance of the difference is not that great, but the effect on reported NCFO may be considerable. For example, they note that for 1999, Xerox Corp. includes $1.495 billion proceeds from receivable financing in its $1.224 reported NCFO.

Mulford & Comiskey (2005, p. 145) also note that in 2002, Halliburton Co. transferred $180 million of accounts receivable in a securitization reported as a sale. As a result, Halliburton (10-K, p. 64) included the proceeds from that sale in NCFO for 2002. Mulford & Comiskey (2005, p. 146) note that although this treatment is proper under GAAP, the problem from an analyst's viewpoint is that an outright sale or securitization of accounts receivable accelerates what would be future NCFO into the current period:

[97] The criteria under SFAS-140 for distinguishing receivable transfers that are sales from those that are collateralized borrowing are summarized later. See Section VII E.16, *Repurchase/Reverse Repurchase Agreements*.

> Thus, collection is accelerated because a portion of operating cash flow in the current period is effectively borrowed from the future. Although new receivables may be sold or securitized in that future period, new receivables would serve only to replace those sold previously. Only an incremental amount of receivables sold would serve to increase operating cash flow.

In the future, moreover, Mulford & Comiskey (2005, p. 146) note that if a company sought to reduce the amount of receivables sold or securitized, NCFO would decline. They (ibid., p. 147) note that this is exactly what happened to Halliburton in 2003, when it reduced the amount of securitized receivables by $180 million in 2003.

From a finance perspective, the distinction between receivable transfers that are sales versus collateralized borrowings under SFAS-140 is not substantial; the cash flows could be virtually identical. Accordingly, we have another instance of no fine dividing line between operating and financing activities. However, we still need to distinguish between operating and financing activities in the cash flow statement, despite some unavoidable arbitrariness.

The SFAS-140 distinction between receivable transfers that are sales versus collateralized borrowings is sufficient to warrant a different financial accounting for balance sheet and income statement purposes. On pragmatic grounds, it seems reasonable to retain the SFAS-140 distinction to classify the related cash flows as either operating or financing, much as we retain the GAAP accrual distinction between an asset and an expense to classify cash outlays as operating or investing outflows. As a result, of course, classifying receivable transfers as operating or financing activities in the cash flow statement will be tied to the GAAP accrual distinction between sales versus collateralized borrowings under SFAS-140. Moreover, this GAAP accrual distinction in the cash flow statement is not avoided by reporting FCF rather than NCFO and NCFI.

E.14. Payments to Settle Pension Liabilities

SFAS-95 (¶ 21) notes that cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income. It (¶ 23(b)) also notes that operating cash outflows includes cash payments made to suppliers and employees for goods and services. Following SFAS-95, the SEC (2005) notes that contributions to pension plans are operating outflows because they relate to employee compensation expense. Prior to 2005, some companies reported such payments as financing outflows, with a resulting favorable effect on reported NCFO and FCF.[98]

[98]…The SEC (2005) notes that registrants that reorganize in bankruptcy often enter into agreements with the Pension Benefit Guaranty Corporation (PBGC) to settle their pension plan liability by an assumption by the PBGC; and that such agreements with the PBGC typically require payments by the registrant at, and/or subsequent to, emergence from

Paying pension obligations, like paying wages payables, results from purchasing employee services on credit. For both, payment is delayed. Accordingly, both are operating activities with a financing dimension. Heath [1978, pp. 130-32] suggests that wage liabilities should be excluded from financing activities because they are spontaneous financings incidental to a company's operations, not negotiated financings with banks and other financial institutions. I concur and extend the analysis to pension liabilities. From a finance perspective, contributions to pension plans represent payments to settle pension obligations to employees, not creditors. Accordingly, they should be classified as operating outflows, not financing outflows. The report user should understand, however, that classifying cash flows into three separate categories involves a certain unavoidable arbitrariness.

E.15. Sale-Leaseback Transactions

In a sale-leaseback transaction, a seller-lessee sells property to a buyer-lessor who then leases the property back to the seller-lessee. These transactions enable seller-lessees to use assets without tying up large amounts of scarce capital. Because the sales price and the leaseback rentals are interrelated — the higher the rentals, ceteris paribus, the higher the sales price — FASB Statement No. 13, *Accounting for Leases* (SFAS-13, 1976, ¶ 107) concludes that no objective basis exists for separating the sale and the leaseback. Rather, SFAS-13 (¶ 32-33) uses a single transaction perspective to view the sale-leaseback transaction as equivalent to a collateralized loan, referred to here as a major leaseback under FASB Statement No. 28, *Accounting for Sales with Leasebacks* (SFAS-28, 1979, ¶ 10-14). The seller/lessee defers any gain or loss on the sale and amortizes it (1) in proportion to the amortization of the leased asset (straight-line for land), if the leaseback is a capital lease, or (2) in proportion to the gross rental expense over the period of expected asset use, if the leaseback is an operating lease.

Under collateralized loan treatment, conceptually a seller-lessee should report cash inflows from major leasebacks as financing inflows and a buyer-lessor should report cash outflows for the purchase-leaseback as investing outflows. In practice, however, Mulford & Comiskey (2005, pp. 151-52) report that sales proceeds are usually classified as financing inflows when the leaseback is a capital

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bankruptcy for the defined benefit plans assumed by the PBGC. Although such payments to the PBGC under these agreements may continue for several years, the SEC (2005) notes that these payments should be classified as operating outflows, not financing outflows; the form of settlement of the pension liability does not change the substance of the activity for which cash is being paid to any other classification than as an operating activity. The SEC (2005) also notes that the classification of these payments as an operating activity does not change in the event the registrant is required to apply "fresh start reporting" pursuant to AICPA Statement of Position 90-7, *Financial Reporting by Entities in Reorganization under the Bankruptcy Code*, upon emergence from bankruptcy.

lease, but as either investing or financing inflows when the leaseback is an operating lease.[99] Nurnberg & Largay (1996, p. 128) note that reporting major sale-leasebacks as investing rather than financing inflows by seller-lessees seems to reflect an emphasis on form over substance— relying on the term "sale" in sale-leaseback rather than the substance of the underlying collateralized loan transaction, presumably in order to boost FCF broadly defined.

Nurnberg & Largay (1996, pp. 128-129) maintain that there is no real ambiguity here in applying SFAS-95, at least as the FASB intended the investing-financing distinctions to work. Sale-leasebacks are financing activities, not investing activities. The income statement and balance sheet reporting of leases are "rule-driven" under SFAS-13, however, and this has apparently carried over to the cash flow statement. Accordingly, we need more specific guidance from the FASB to preclude continued cash flow classification of sale-leaseback transactions as investing activities based on form over substance.

E.16. Repurchase/Reverse Repurchase Agreements

In a repurchase agreement (henceforth repo, plural repos), an entity sells securities to another party and agrees to repurchase those securities at an agreed-upon price at a stated time. A reverse repurchase agreement (henceforth reverse repo, plural reverse repos) is a repo from the perspective of the other party. Repos and reverse repos are entered into by both non-financial and financial companies, but much more often by the latter than by the former.

Income Statement Reporting

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS-140, 2000), prescribes the accounting for transfers of financial assets, including repos and reverse repos. Under SFAS-140 (¶ 9), a transfer of financial assets in which the transferor surrenders control over those assets is a sale to the extent that consideration (other than beneficial interests in the transferred assets) is received in exchange. A transferor surrenders control over transferred assets if and only if all of the following conditions are met:

[99] In contrast to the single transaction perspective applied to major leasebacks, a dual transaction perspective applies when most of the risks and rewards are transferred to the buyer-lessor--the minor leaseback of FASB Statement 28 (SFAS-28, 1979a). Because most of the risks and rewards are transferred to the buyer-lessor in a minor leaseback, the transaction is viewed as equivalent to a separate sale and purchase of property, and the seller-lessee recognizes gain immediately. Following the classification of proceeds from the sale of plant assets under SFAS-95, a seller-lessee should report cash inflows from a minor sale-leaseback as investing inflows. Similarly, following the distinction between outlays for inventory and plant assets under SFAS-95, a buyer-lessor should report cash outflows from minor leasebacks as operating or investing outflows depending, respectively, on whether the buyer-lessor is a dealer or non-dealer in the leaseback property.

(a) The transferred assets have been isolated from the transferor— placed beyond the reach of the transferor and its creditors, even in bankruptcy or receivership.

(b) Each transferee has the right to pledge or exchange the assets it received, and no constraint on the transferee from pledging or exchanging the assets provides more than a trivial benefit to the transferor.

(c) The transferor does not maintain effective control over the transferred assets by other means.

SFAS-140 (¶ 47, 49) provides additional guidance on meeting the effective control criteria.

Under SFAS-140 (¶ 98), when all of the above criteria are met, the transferor accounts for a repo as a sale of financial assets and a forward repurchase commitment, and the transferee accounts for the reverse repo as a purchase of financial assets and a forward resale commitment.[100] Under SFAS-140 (¶ 100), repos that do not meet all of the above criteria are treated as secured borrowings by the transferor and transferee.

According to AICPA *Audit and Accounting Guide: Depository and Lending Institutions* (AICPA, 2005, ¶ 14.08), "[t]he terms of the [repurchase and reverse repurchase] agreements often provide criteria to determine whether the securities are similar enough to make the transaction, in substance, a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities. For agreements involving securities collateralized by dissimilar pools, those transactions are accounted for as sales and purchases of securities." Accordingly, each repo and reverse repo is evaluated as to whether it is a sale or purchase of the underlying security or a secured borrowing under SFAS-140. That accounting determines the appropriate cash flow reporting under SFAS-102.

A *dollar roll* is a repo to sell and repurchase similar but not identical securities, e.g., securities of the same agency, but not the original securities.[101] The most common types of dollar rolls are fixed coupon dollar roll and yield maintenance dollar roll agreements.

A *fixed coupon dollar roll* requires repurchase of securities with the same stated interest rate as, and maturities similar to, the securities sold and are generally priced to result in substantially the same

[100] Other transfers that are accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

[101] According to the AICPA (2005, ¶ 14.05), a dollar roll market usually involves mortgage-backed securities. The securities sold and repurchased are usually of the same issuer, are represented by different certificates, are collateralized by different but similar mortgage pools (e.g., single-family residential mortgages), and generally have different principal amounts.

yield. The seller-borrower retains control over the future economic benefits of the securities sold and assumes no additional market risk. Accordingly, a fixed coupon dollar roll is accounted for as a secured borrowing by both the seller-borrower and the buyer-lender.

In a *yield maintenance dollar roll*, the securities repurchased may have a different stated interest rate and are generally priced to result in different yields from that of the securities sold. The seller-borrower surrenders control over the future economic benefits of the securities sold and assumes additional market risk.[102] Accordingly, a yield maintenance dollar roll is accounted for as a sale by the seller-borrower and as a purchase by the buyer-lender.

Cash Flow Statement Reporting under Extant GAAP

The AICPA Audit and Accounting Guide: Depository and Lending Institutions (AICPA, 2005, ¶ 6.20) calls for classifying repo cash flows as financing activities and reverse repo cash flows as investing activities, as follows:

Financing Activities	
Cash Inflows	*Cash Outflows*
Net increase in repos and dollar repos	Net decrease in repos and dollar repos
Investing Activities	
Cash Inflows	*Cash Outflows*
Net decrease in reverse repos	Net increase in reverse repos

This guidance seems to be followed by most depository and lending institutions that report separate line items for repos and reverse repos in their cash flow statements. However, the guidance in paragraph 6.20 of the AICPA guide seems to be incomplete and inconsistent. For one thing, it does not explicitly address the distinction between fixed coupon and yield maintenance dollar rolls. Additionally, it distinguishes between repos and dollar repos but not between reverse repos and reverse dollar repos. Finally, the AICPA Guide does not apply to other types of financial companies.

As a result, cash flow statement classification varies across different types of financial companies. In particular, depending on the facts and circumstances, as well as on how SFAS-95, SFAS-102 and SFAS-140 are applied, cash flows from fixed coupon dollar roll repos may be reported as either operating or financing activities by the seller-borrower, and as either operating or investing

[102] According to the AICPA (2005, ¶ 14.06) yield maintenance dollar roll may contain par cap provisions that could significantly alter the economics of the transactions.

activities by the buyer-lender under SFAS-95. Similarly, cash flows from yield maintenance dollar roll repos may be reported as either operating or investing activities by the seller-borrower, and as either operating or investing activities by the buyer-lender under SFAS-95.

Although not explicitly addressed in the authoritative GAAP literature, operating activity classification may result from treating reverse repos as cash equivalents under SFAS-95, as suggested by Stewart et al. (1988, p. 4), or as trading securities under SFAS-102 (¶ 9), provided that reverse repos are trading activities. (SFAS-95, SFAS-102, SFAS-115, and the AICPA Guide do not list reverse repos as cash equivalents or as trading securities, but they seem to qualify under SFAS-95 and SFAS-115 criteria.) Similarly, although not explicitly addressed in the authoritative GAAP literature, operating activity classification of repos results from treating them as negative cash equivalents under SFAS-95, or as negative reverse repos under SFAS-102, again provided that repos are trading activities.[103] Presumably, if classified as operating activities, material repo and reverse repo cash flows might be reported as separate line items in deriving NCFO under the direct method. However, almost all companies use the indirect method. As a result, if classified as operating activities, material repo and reverse repo cash flows presumably are buried in NCFO without separate disclosure.

For example, in the cash flow statement included in its fiscal 2005 10-K, Morgan Stanley reports a $4,387 million line item in the reconciliation of net income and NCFO for the change in *securities sold under agreements to repurchase net of securities purchased under agreements to resell*; it does not report either repos or reverse repos among investing or financing activities. Morgan Stanley (ibid., note 2, p. 118) notes that it changed the cash flow statement classification of repos net of reverse repos from financing activities to operating activities in fiscal 2005; and that the classification change increased (decreased) NCFO by $(2,917) million and $8,172 million, and increased (decreased) NCFF by $2,917 million and $(8,172) million in fiscal 2004 and fiscal 2003, respectively. Morgan Stanley notes that it "…believes the change in classification of repurchase transactions is preferable because it is more consistent with the classification used by peer companies and it reflects better the primary business purpose of these transactions." Goldman Sachs also seems to report repos net of reverse repos as operating activities in its cash flow statement.[104] More specifically, in the cash flow statement

[103] The concept of a negative cash equivalent (or loan) contradicts the basic accounting model and as well as the definition of cash equivalents in SFAS-95. Nevertheless, some companies employ it in their cash flow statements. Possible justifications for this apparent departure from U.S. GAAP include lack of materiality and arguing that such presentations emphasize substance over form. See Thompson & Bitter, 1993, p. 20. Additionally, IASB-7 (¶ 8) permits negative cash equivalents in some circumstances, as noted earlier.

[104] Goldman Sachs (2005 10-K, p. 7) discloses that it trades and makes markets in a variety of interest rate products, including repos and other highly liquid securities and instruments. It (2005 10-K, p. 123) also discloses that it obtains

included in its fiscal 2005 10-K, Goldman Sachs reports a $62,269 million line item in the reconciliation of net income and NCFO for the change in securities sold under agreements to repurchase net of securities purchased under agreements to resell; it does not report either among investing or financing activities.

Excluding those in trading accounts, because fixed coupon dollar roll repos are accounted for as secured borrowings, seller-borrowers could classify cash inflows as financing inflows (principal), and cash outflows as financing outflows (principal) and operating outflows (interest) under SFAS-95. Analogously, buyer-lenders of fixed coupon dollar roll reverse repos could classify cash outflows as investing outflows (principal), and cash inflows as investing inflows (principal) and operating inflows (interest) under SFAS-95. For example, the 2004 comparative cash flow statement of Wachovia Corporation and Subsidiaries reports a $12,031 million net financing outflow for 2004 and a $13,488 million net financing inflow for 20x3 for *Securities sold under repos and other short-term borrowings, net*. Similarly, the 2004 cash flow statement of JPMorgan Chase reports a $7,065 million net financing inflow for Federal funds purchased and securities sold under repos; and the 2004 cash flow statement of Bank of America reports a $35,752 million financing inflow for *Net increase in federal funds purchased and securities sold under agreements to repurchase*.

Excluding those in trading accounts, because yield maintenance dollar roll repos are accounted for as sales and purchases of the underlying securities, seller-borrowers could classify cash inflows as investing inflows, and cash outflows as investing outflows (principal) and operating outflows (interest) under SFAS-95, especially if the term exceeds three months.[105] Analogously, buyer-lenders of yield maintenance dollar roll reverse repos could classify cash outflows as investing outflows, and cash inflows as investing inflows (principal) and operating inflows (interest) under SFAS-95, again especially if the term exceeds three months. For example, the 2003 comparative cash flow statement of Wells Fargo & Co. reports a $483 million investing inflow for 2003 and a $475 million investing outflow for 20x2 for *Net Decrease (Increase) in Federal Funds Sold and Securities Purchased under Resale Agreements*. Similarly, the 2004 cash flow statement of JPMorgan Chase reports a $13,101 million net investing outflow for *Federal funds sold and securities purchased under resale agreements*; and the 2004 cash flow statement of Bank of America reports a $3,880 million investing outflow for *Net increase in federal funds sold and securities purchased under agreements to resell.*

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secured short-term financing principally through the use of repos, securities lending agreements and other financings. But it includes cash flows from repos net of reverse repos in NCFO.

[105] For maturities of three months or less, SFAS-95 (¶ 8, 13) permits cash equivalent classification of qualifying securities and net cash flow reporting of certain investments and borrowings.

Evaluation

The varied classification of repos and reverse repos under SFAS-95 and SFAS-102 appears to impair intercompany comparability, but the facts and circumstances might prove otherwise. Some financial companies may include repos and reverse repos in cash equivalents, a part of their cash management, an operating activity under SFAS-95 and SFAS-102. However, I cannot document specific companies that follow this practice. Other financial companies, such as Morgan Stanley and Goldman Sachs, view repos and reverse repos like negative and positive inventory, a part of their inventory management, a trading activity reported as an operating activity under SFAS-95 and SFAS-102. Still other financial companies, mainly banks, report repos as borrowing (financing) activities, and reverse repos as lending (investing) activities. Accordingly, differences in how companies manage repo and reverse repo transactions result in different cash flow statement classification of otherwise identical cash flows. But these different cash flow statement classifications reflect real-world differences in how different companies operate.[106] Absent a major revision of SFAS-95, disclosing the nature and reasons for the classification policy and presenting gross rather than net cash flows enhances intercompany comparability and fineness of reported cash flows.

E.17. Hedging Transactions

SFAS-149 (¶ 37) amends SFAS-95 (already amended by SFAS-104 and SFAS-133) by noting that each cash inflow or outflow is generally classified according to its nature without regard to whether it stems from an item intended as a hedge of another item. For example, proceeds from a borrowing are a financing cash inflow even though the debt is designed to hedge an investment, and the purchase or sale of a futures contract is an investing activity even though the contract is designed to hedge a firm purchase commitment.

However, SFAS-149 (¶ 37) permits classifying the cash flows from a derivative instrument that is accounted for as a fair value or cash flow hedge (under SFAS-133) in the same category as the cash flows from the items being hedged, provided that

> (1) the derivative instrument does not include a significant financing element at inception (other than a financing element inherently included in an at-

[106] Under current GAAP, differences in management policies and intent result in different cash flow statement classification of otherwise identical cash flows from repos and reverse repos. One might argue that it is preferable not to base differences in cash flow statement classification on differences in management intent. Rather, one might favor the same cash flow statement classification of repos and reverse repos by all companies. Reasoning along these lines, one might argue that, from a finance perspective, repos and reverse repos are (1) financing activities of non-financial companies, not operating or investing activities; and (2) financing (borrowing) activities and investing (lending) activities, respectively, of financial companies. But this viewpoint runs counter to the notion that differences in how companies manage repos and reverse repos reflect real-world differences among companies, and that financial accounting should reflect these real world differences.

the-market derivative instrument with no prepayments, i.e., the forward points in an at-the-money forward contract), and

(2) the accounting policy is disclosed.

Because this classification rule is voluntary, the cash flows from a derivative instrument that is accounted for as a fair value or cash flow hedge could be reported either as operating or investing flows.[107]

On the other hand, if the derivative instrument includes an other-than-insignificant financing element at inception, SFAS-149 (¶ 37) requires that all cash inflows and outflows of the derivative instrument should be classified as financing cash flows by the borrower. SFAS-149 (¶ A39) notes two characteristics often associated with a derivative that contains a financing element—up-front cash payments and off-market terms (for example, terms, rates, or prices not consistent with the current market for that type of contract).[108] The FASB reasons (SFAS-149, ¶ A39) that although "it may be conceptually preferable to report only those cash flows associated with the financing element as a financing flows, identifying those cash flows would be difficult." Because of cost-benefit concerns, the FASB decided to classify all cash inflows and outflows associated with derivatives that contain an other-than-insignificant financing element at inception as financing cash flows.

As a result, some operating flows are reported as financing cash flows under SFAS-149. From a finance perspective, it would be preferable to report only those cash flows associated with the financing element as financing flows, and to report the other cash flows as operating flows. Even with full disclosure, it is problematic whether financial report users could make the adjustment themselves. Better have the reporting company make the split. After all, it is the reporting company that entered into the derivative transaction; accordingly, it should know the operating and financing components.

In summary, this subsection examined the cash flow statement reporting of each of seventeen different transactions. Because SFAS-95 does not unambiguously classify cash flows from these transactions, the classifications and NCFO, NCFI, and NCFF subtotals are not comparable across companies. The problems caused by lack of comparability could be reduced by disclosures to make the

[107] If hedge accounting for an instrument that hedges an identifiable transaction or event is discontinued for any reason, SFAS-149 (¶ 37) requires that any cash flows subsequent to the date of discontinuance should be classified consistent with the nature of the instrument.

[108] However, SFAS-149 does not establish specific criteria for determining when a derivative contains a financing element because of the unlimited ways of structuring derivatives. Rather, SFAS-149 (¶ A39) notes that identifying a financing element should be based on the specific facts and circumstances. Additionally, the presence of only an insignificant financing element at inception does not warrant classifying a derivative's cash flows as financing flows. However, when an other-than-insignificant financing element is present at inception, the borrower in the arrangement should report all of the derivative's cash flows as financing flows.

differences in classifications transparent. However, often the disclosures relating to these transactions are limited, especially the disclosures relating to their cash flows. The lack of transparency in cash flow reporting is important because it potentially impairs the reliability of investment decisions based on the NCFO, NCFI, NCFF subtotals and on FCF. The lack of comparability also impairs the reliability of empirical studies that take reported cash flow captions and subtotals directly from published cash flow statements without adjustment.

VIII. Non-cash Investing and Financing Transactions

Non-cash investing and financing transactions do not involve cash collections or payments but may be significant to evaluating the investing and financing activities reported in the cash flow statement. Examples of non-cash investing and financing transactions include (1) converting debt to equity, or vice versa (2) acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller, (3) obtaining an asset by entering into a capital lease, and (4) exchanging non-cash assets or liabilities for other non-cash assets or liabilities.

In the Exposure Draft to SFAS-95 (ED, 1986, ¶ 4), the FASB proposed that the primary purpose of the cash flow statement is to provide information about cash receipts and cash payments, and that a secondary purpose is to provide information about the investing and financing activities. Consistent with these two purposes, the Exposure Draft required disclosure of non-cash investing and financing transactions either in the cash flow statement or in a separate schedule. Formerly, such transactions were reported as non-fund investing and financing activities in the statement of changes in financial position. By permitting disclosure of these non-cash investing and financing transactions in the cash flow statement, the Exposure Draft held open the possibility that a comparative cash flow statement for a series of years, like the predecessor comparative statement of changes in financial position, would report all the investing and financing activities of a firm.

Unlike the Exposure Draft, however, SFAS-95 (¶ 4) retains the primary purpose but deletes the secondary purpose of the cash flow statement. The FASB concluded that the effectiveness of the cash flow statement would be enhanced if its purpose was restricted to reporting only cash flows, and therefore prohibits reporting non-cash transactions in the cash flow statement. Nevertheless, SFAS-95 requires (¶ 32) disclosure of all non-cash investing and financing transactions that affect recognized assets or liabilities but that do not result in cash inflows or outflows. The FASB reasons (SFAS-95, ¶ 70) that although these non-cash transactions result in no cash inflows or outflows in the periods in which they occur, they generally have a significant effect on cash flows in subsequent periods. SFAS-95 makes more uniform the reporting of non-cash investing and financing transactions by prescribing supplemental disclosure outside the cash flow statement and prohibiting their disclosure in the cash flow statement. Unfortunately, the result of this narrower focus is that a comparative cash flow statement, unlike a comparative statement of changes in financial position, does not report all of a firm's investing and financing transactions.

For example, if a firm acquires equipment under capitalized leases, the inception of the lease is a non-cash investing and financing transaction to be disclosed outside the cash flow statement, whereas

the subsequent lease payments are allocated between interest and principal and reported in the cash flow statement as operating and financing outflows, respectively. Accordingly, a comparative cash flow statement for a series of years does not report all investing and financing transactions relating to this lease. Neither the original investment outflow nor the original borrowing inflow is reported in the cash flow statement, but the repayment is reported later as a financing outflow. From a cash flow statement perspective, the firm appears to be paying off a phantom loan, although the loan itself is reported in the balance sheet.

A similar result occurs when a firm acquires real estate by assuming an existing mortgage or by giving a mortgage or installment note to the seller. Only the down payment is reported as an investing outflow; all subsequent principal payments are reported as financing outflows. Still another example of the incomplete reporting of financing activities in the cash flow statement under SFAS-95 is the conversion or exchange of debt for equity. A comparative cash flow statement reports the original borrowing as a financing inflow, but settlement of the debt by conversion or exchange is not reported as a financing outflow because it does not involve cash.

Where non-cash transactions are excluded, a series of cash flow statements may not report all investing and financing activities. Additionally, companies may enhance reported NCFO and FCF as a result of certain non-cash financing transactions. For example, in the fourth quarter of 2002, Delphi Corp. elected to defer payment on $287 million in accounts payable through a financing arrangement with General Electric Credit Corp. Pursuant to the agreement, General Electric Credit provided financing to cover amounts due from Delphi to its suppliers for purchases of goods and services, with subsequent payment to General Electric Credit during the first quarter of 2003. As a result of this non-cash financing transaction, Delphi Corp. avoided $287 million of operating cash outflows to its suppliers in 2002, whereas the $287 payment to GEC in 2003 was classified as a financing outflow. Accordingly, this non-cash financing transaction resulted in changing the classification of the $287 outflow from operating to financing, thereby enhancing 2002 reported NCFO by $287 million.[109]

A. Unclear Disclosure Requirements

SFAS-95 requires supplemental disclosure of non-cash investing and financing transactions. However, as Nurnberg (1993, pp. 69-70) notes, SFAS 95 does not unambiguously specify which non-cash transactions require disclosure and which do not. For the most part, the non-cash investing and financing transactions for which separate disclosure is explicitly required by SFAS-95 involve external

parties and were formerly reported in the statement of changes in financial position as separate non-fund sources and uses of funds.

Under prior practice, each of these non-cash transactions was typically viewed as equivalent to two hypothetical transactions, a cash inflow and a cash outflow of equal amount. For example, because acquisitions of equipment under capitalized leases were viewed as equivalent to long-term borrowings followed by immediate payments to acquire equipment, such external non-cash transactions were reported in the statement of changes in financial position as non-fund sources and uses of funds. As noted earlier, they must also be disclosed under SFAS-95, but not in the cash flow statement.[110]

Although the rationale of two hypothetical cash transactions is satisfactory for some purposes, it opens the way for other hypothetical interpretations which are not so acceptable. As Moonitz (1956, 380) noted long ago, it is preferable to emphasize that funds flow as a result of external transactions, rather than postulate hypothetical cash transactions. Thus, stock dividends were not usually reported in the statement of changes in financial position, even though stock dividends could be viewed as equivalent to two hypothetical transactions— payment of a cash dividend followed immediately by issuance of stock to the same stockholders for cash. Besides, stock dividends were adequately reported in the statement of changes in stockholders' equity. For similar reasons, stock dividends do not represent non-cash financing transactions requiring disclosure under SFAS-95, presumably because they are not external transactions and also because they are adequately disclosed elsewhere in financial reports. Nevertheless, stock dividends are occasionally disclosed among non-cash financing activities. As an example, in its 1991 Annual Report (pp. 17, 25), Commerce Clearing House reports a $17.42 million common stock dividend among the supplementary disclosures of non-cash financing activities; it also reports the stock dividend in its statement of changes in stockholders' equity.

Several authors (see, e.g., Mosich 1989, 1187; Seiler 1991, 8-22; Williams et al. 1989, 1185-86) conclude, however, that cash dividend declarations per se are non-cash financing transactions requiring disclosure under SFAS-95 when the amounts declared differ from the amounts paid during the year. This issue is not addressed explicitly in SFAS-95. In practice, a few firms (see, e.g., Cash America Investments; Farmland Industries; Larrizza Industries) disclose dividend declarations with the disclosures of non-cash investing and financing activities. Presumably, most firms conclude that any

[109] At least for publicly-owned companies, the SEC announced in December 2005 that such third-party inventory financings should be reported in the cash flow statement of the buyer as financing inflows and operating outflows. See Section VII E.12, *Notes Payable*.

[110] Additionally, SFAS-95 is not clear as to whether an initial lease payment at lease inception is an investing outflow representing an initial down payment on an installment purchase; or a financing outflow representing a repayment of an amount borrowed.

differences between dividends declared and dividends paid are adequately disclosed by comparing amounts reported in the cash flow statement and statement of changes in stockholders' equity.

Prior to SFAS-95, reclassifications of non-current liabilities as current liabilities often were reported as non-fund resources applied and provided in the funds statement because "…the pool of net disposable money-assets or of net working capital ... [was] diminished ... [by] an event giving rise to a decline in funds" (Moonitz 1956, p. 362). Although not explicitly considered in APB-19, some authors (see, e.g., Kieso and Weygandt 1983, p. 1087; Miller et al. 1982, p. 767) interpreted that pronouncement to require disclosure of debt reclassifications as non-fund resources provided and applied, whereas other authors (see, e.g., Davidson et al. 1985; Danos and Imhoff 1986) did not address the issue.

SFAS-95 does not explicitly consider whether debt reclassifications should be disclosed as significant non-cash financing activities. Some authors (see, e.g., Mosich 1989, p. 1183) interpret SFAS-95 to require disclosure of debt reclassifications as non-cash financing activities, whereas other authors (see, e.g., Chasteen et al. 1989; Kieso and Weygandt 1989; Nikolai and Bazley 1991; Seiler 1989; Smith and Skousen 1990; Welsch and Zlatkovich 1989; Williams et al. 1989) do not address the issue. In practice, few firms (see, e.g., DST Systems Inc.; Mechanical Technology Incorporated; Pacific Enterprises; Rent-A-Wreck of America, Inc.; and. Simetco Inc.) disclose debt reclassifications along with disclosures of non-cash investing and financing activities. Most such disclosures involve reclassifications from current to non-current, not non-current to current.

B. Third-Party Financing Transactions

Although the cash flow statement reports only cash flows, SFAS-95 does not provide adequate guidance as to whether cash actually flows in some third-party financing transactions. Cash inflows occur as checks are received and deposited, and cash outflows occur as checks are issued, but some third-party financing transactions do not involve deposits and issuances of checks.

For example, assume a company obtains third-party financing for equipment purchases. The third-party creditor issues a check payable to the company, which the company immediately endorses over to the equipment dealer rather than depositing it and issuing its own check. Does receipt of the third-party check constitute a cash inflow? Does endorsement of the check constitute a cash outflow? SFAS-95 does not provide definitive guidance. Some companies report such transactions gross, as both financing inflows and investing outflows, whereas other companies report such transactions net in the cash flow statement with supplemental disclosure among non-cash financing and investing activities, but the variations cannot be documented from published cash flow statements. Does the reporting

change if the check is payable to the equipment dealer but given to the company which in turn gives it to the dealer? Does the reporting change if the third-party creditor mails the check directly to the equipment dealer? Again, SFAS-95 does not provide definitive guidance.[111]

Limited guidance is provided for third-party financing provided by banks. Here the FASB reasons (SFAS-95, ¶ 7, fn. 1) that because cash includes demand deposits, charges and credits to a demand deposit account are cash receipts and cash payments to both the company owning the account and the bank holding it. Accordingly, for third-party financing provided by banks, the transaction is reported gross if the company's demand deposit account is increased for the loan and decreased for the payment, regardless of whether the company endorses or conveys a bank check to the equipment dealer. The transaction is reported net, however, if the company's demand deposit account is not affected by the loan and subsequent payment. Thus, the cash flow statement presentation of the transaction by the borrower depends on the internal accounting for the transaction by the lender![112] This is contrary to the usual situation where the financial reporting of a transaction by one company is unaffected by the financial reporting by the other party to the transaction.

Additionally, the SEC announced in December 2005 that certain third-party inventory financings should be reported in the cash flow statement of the buyer as financing inflows and operating outflows, as noted previously.[113]

[111] These issues were considered by the FASB at a meeting on 26 October 1988. The FASB promised some additional guidance, but in the form of a journal article by a FASB staff person rather than a question and answer implementation guide. Unfortunately, the staff person left the FASB before completing the journal article.

[112] Similarly, when a company rolls over a certificate of deposit upon maturity, the bank may or may not increase and decrease the company's demand deposit account, yet the FASB reasons (SFAS-104, ¶ 20) that one procedure results in a cash inflow and a cash outflow, whereas the other results in neither. Thus, the company whose bank increases and decreases its demand deposit account when a loan or certificate of deposit is renewed reports higher cash flows relative to another company whose bank does not adjust its demand deposit account for such renewals.

[113] See Section VII E.12, *Notes Payable*.

IX. Definition and Calculation of Free Cash Flow

As noted previously, GAAP does not define FCF, and users define FCF in a variety of ways. Ideally, if FCF is to be reported in the cash flow statement, it should be defined unambiguously, with full disclosure of its components, to enhance comparability across companies. (Even if not reported in the cash flow statement, uniform definition of FCF by different analysts would make analysts' reports more comparable.) However, much as the classification of cash flows should differ for non-financial and financial companies, the definition of FCF should differ for non-financial and financial companies. For both non-financial and financial companies, FCF should be defined as NCFO less NCFI. However, as noted above, the cash flow statement classification rules should differ for non-financial and financial companies. Accordingly, NCFO and NCFI should be defined differently for non-financial and financial companies.

A. Definition for Non-financial Companies

For non-financial companies, FCF should be defined as NCFO before net interest payments but after income taxes, less net investment outflows to purchase plant assets, intangibles, and other businesses.[114] NCFO should exclude the income tax effects of investing and financing transactions; FCF should exclude the income tax effects of financing transactions.

Net interest payments means interest payments less interest collections on debt securities held to park excess cash balances. Net outflows means gross investment outflows to purchase property, plant, equipment, intangibles, and other businesses, less investment inflows from selling property, plant, equipment, intangibles, and other businesses. Including both investment inflows from sales and investment outflows for purchases in FCF makes the metric more comparable for companies that turn over these long-term assets with companies that do not. Both should be included in FCF but not in NCFO.

Similarly, including outflows for purchases of other businesses in FCF makes the metric comparable for companies that acquire assets directly from suppliers, with companies that acquire assets by acquiring other businesses; including inflows from sales of other businesses in FCF makes

[114] FCF should include all investing outflows without distinguishing investing outflows to maintain existing capacity from investing outflows to expand capacity. (When suggested, the distinction usually applies to plant assets, but it is also applicable conceptually to all assets, including intangibles.) Some suggest that expenditures to maintain capacity are not discretionary and should be deducted from NCFO to derive FCF; but that expenditures to expand productive capacity are discretionary and should not be deducted from NCFO to derive FCF. The resulting FCF is then discretionary FCF available for expansion, dividends, etc. As SFAS-95 (¶ 97-99) notes, however, making this distinction in the cash flow statement is not practicable. Although potentially relevant to report users, the resulting information would be too subjective to be reliable. However, users might want to estimate these amounts themselves for analytical purposes.

the metric comparable for companies that dispose of long-term assets by selling them separately, with companies that dispose of long-term assets by disposing of businesses. Again, both should be included in FCF but not in NCFO.

For non-financial companies, interest payments and interest collections on non-trading debt securities held to park excess cash balances should be excluded from FCF. Like dividend payments, net interest payments should be classified by non-financial companies as financing outflows, not operating outflows. Also for non-financial companies, outflows to purchase and inflows from sales of investments in non-trading debt securities held to park excess cash balances should be excluded from FCF. As explained more fully above, purchases and sales of such securities by non-financial companies are the opposite of borrowing activities, hence are financing activities, not investing activities. Accordingly, cash flows from purchases and sales of such securities should be classified as financing flows, together with any interest collections thereon. As financing flows, they should be excluded from FCF.

B. Definition for Financial Companies

For financial companies, FCF should be defined as NCFO after interest payments on deposit liabilities (but not on bonded debt), interest and dividend collections, and income taxes, less net investment outflows to make (or buy) and collect (or sell) loans, purchase debt and equity securities, plant assets, intangibles, and other businesses, and accept deposits and honor withdrawals. Once again, NCFO should exclude the income tax effects of investing and financing transactions; FCF should exclude the income tax effects of financing transactions.

Extending (or buying) and collecting (or selling) loans are investing activities of financial companies, as are purchases and sales of investments in non-trading debt and equity securities. Accordingly, outflows for making (or buying) loans and investments and inflows from collecting (or selling) loans and investments are investing flows and should be included in FCF (but not in NCFO) of financial companies. However, interest collections on loans and interest and dividend collections on debt and equity securities are operating inflows of financial companies, much as rental collections are operating inflows of rental companies, hence should be included in both NCFO and FCF of financial companies.

Accepting deposits and honoring withdrawals thereon are negative investing activities of financial companies, as explained more fully above, significantly different from obtaining debt capital from bondholders and equity capital from stockholders. Accordingly, inflows for deposits accepted and outflows for withdrawals are investing flows and should be included in FCF (but not in NCFO).

However, interest payments on deposits are operating outflows of financial companies, much as dividend and interest collections are operating inflows, hence should be included in both NCFO and FCF of financial companies.

C. Treatment of Income Taxes in Free Cash Flow

As indicated above, income tax payments (or refunds) should be allocated among operating, investing, and financing activities in the cash flow statement. Accordingly, for both financial and non-financial companies, NCFO (and possibly FCF) should be reported on an after-tax basis.

X. Analytical Adjustments of the Cash Flow Statement

Much as the income statement is a historical report of the revenues and expenses of an enterprise for a period of time, the cash flow statement is a historical report of its cash inflows and outflows for a period of time. A series of income statements is often a good starting point for projecting future revenues and expenses. Similarly, a series of cash flow statements is often a good starting point for projecting future cash inflows and outflows. To make such projections more predictive of future results, analysts exclude transactions not representative of past performance and/or not expected to recur in the future; and they include transactions that are representative and/or expected to occur in the future that did not occur in the past.

The remainder of this section discusses adjustments of cash flows reported in the cash flow statement for analytical purposes, i.e., to underlie operating, investing, and financing decisions. However, this paper does not recommend these adjustments for financial reporting purposes. For the latter purpose, the objective of the cash flow statement should remain to report actual cash flows except for certain hypothetical income tax effects from allocating income taxes among operating, investing, and financing activities. The discussion is organized in five subsections, as follows: (1) prospective (pro forma) cash flows; (2) non-cash transactions; (3) prospective income tax effects; (4) free cash flow for valuation purposes; and (5) classification adjustments.

A. Prospective (Pro Forma) Cash Flows

The objective of the cash flow statement is to report the cash inflows and outflows of an enterprise for a period of time. As such, the cash flow statement is a historical report of cash flows. For analytical purposes, however, the cash flow statement should be adjusted to exclude cash flows that are not anticipated to recur in future periods. Additionally, for analytical purposes, the cash flow statement should be adjusted to include cash flows that did not occur in prior periods but that are anticipated to occur in future periods. For example, analysts typically exclude unusual items, infrequent items, discontinued operations, and extraordinary items of prior periods when estimating net income and earnings per share (EPS) of future periods for analytical purposes. Similarly, analysts should exclude the corresponding nonrecurring cash flows of prior periods when estimating NCFO and FCF of future periods for analytical purposes, whether favorable or unfavorable. For example, an increase (decrease) in raw material outlays due to a temporary increase (decrease) in raw material prices should be excluded from prospective NCFO (and FCF).

Particular attention should be given to changes in cash flows relating to discretionary costs. For example, companies have considerable discretion in determining the level of outlays for advertising,

maintenance, staff training, and research and development. By reducing such outlays, NCFO (and FCF) increases, but such reductions may adversely affect future operations, hence may not be sustainable. Accordingly, the increase in NCFO (and FCF) is not sustainable. To the extent that the analyst concludes that the reduced level of such outlays is not sustainable, prospective NCFO (and FCF) should exclude the portion of current period NCFO (and FCF) attributable to such reduced outlays.

Particular attention should also be given to cash inflows emanating from structured transactions that boost NCFO (and FCF) but are not anticipated to recur in the future. For example, NCFO (and FCF) of some non-financial companies may increase by transferring receivables structured as sales transactions.[115] To maintain NCFO (and FCF) at the same level next year, such companies might need roughly the same volume of receivable transfers next year; to boost NCFO (and FCF) next year, such companies would need to increase the volume of receivable transfers. To the extent that the analyst concludes that maintaining (or increasing) the volume of receivable transfers is not feasible in the future, prospective NCFO (and FCF) should exclude the portion of current period NCFO (and FCF) attributable to such receivable transfers.

Similarly, some non-financial companies may increase NCFO (and FCF) by acquiring or disposing of business units.[116] To maintain NCFO (and FCF) at the same level next year, such companies might need roughly the same volume of acquisitions or dispositions next year; to boost NCFO (and FCF) next year, such companies would need to increase the volume of acquisitions or dispositions. To the extent that the analyst concludes that maintaining (or increasing) the volume of acquisitions or dispositions is not feasible in the future, prospective NCFO (and FCF) should exclude the portion of current period NCFO (and FCF) attributable to such acquisitions or dispositions.

In all cases, the analyst's objective in estimating prospective NCFO (and FCF) is to exclude the cash flow effects of the current period NCFO (and FCF) that are not expected to recur in the future.

B. Non-cash Transactions

Except for the hypothetical income tax savings from the windfall stock option deduction, the cash flow statement is a historical report of actual cash flows.[117] As a result, it does not include hypothetical cash flows of non-cash transactions. To project future NCFO, future FCF, and future cash flows

[115] See Section VII E.13, *Sales or Transfer of Receivables*.
[116] See Section VII E.9, *Acquisitions and Dispositions of Businesses*.
[117] Another exception, at least for publicly-owned companies, is reporting third-party inventory financings as financing inflows and operating outflows, as mandated by the SEC in 2005. See Section VII E.12, *Notes Payable*.

generally, the cash flow statement should be adjusted to include the hypothetical cash flows of non-cash transactions that are representative of past performance and/or expected to occur in the future and involve actual cash. For example, as calculated directly from the cash flow statement, FCF includes cash outflows for plant assets but not hypothetical cash flows for plant assets acquired in exchange for capital stock. In certain situations, however, FCF should be adjusted for analytical purposes to include hypothetical cash flows of non-cash plant assets acquisitions. Such adjustments are called for when comparable plant acquisitions in future periods will require cash outlays. That way, adjusted FCF will be more representative of FCF of future periods when all plant acquisitions are for cash.

C. Prospective Income Tax Effects

As indicated above, the actual income tax payments (and refunds) of the current period should be allocated in the cash flow statement among operating, investing, and financing activities so that (1) NCFO is uncontaminated by the income tax effects of investing and financing activities; (2) FCF (if reported) is uncontaminated by the income tax effects of financing activities; and (3) the actual NCFO, NCFI and NCFF (and possibly FCF) subtotals are reported on an after-tax basis.

However, financial analysts use NCFO and FCF on a prospective (as opposed to actual) after-tax basis to estimate total shareholder value and total company value. Accordingly, when used to estimate total shareholder value or total company value using a discounted future cash flow (DCF) approach, actual after-tax FCF should be adjusted to a prospective after-tax basis. In adjusting actual after-tax FCF to a prospective after-tax basis, FCF should be adjusted for all income tax effects properly allocable thereunto, regardless of whether paid (or collected) in the current period or just accrued or deferred.

The starting point for calculating prospective after-tax FCF for analytical purposes is actual after-tax FCF, i.e., after allocating actual income tax payments (or refunds) for the period. By allocating actual income tax payments (or refunds), actual after-tax FCF will exclude income tax payments (or refunds) of the current period that are attributable to financing activities. For valuation purposes, however, prospective after-tax FCF should also exclude any income tax payments (or refunds) not anticipated in future periods. Thus, prospective after-tax FCF should exclude income tax payments (or refunds) attributable to infrequent, unusual, or extraordinary operating activities that are not expected to recur in the future. Similarly, prospective after-tax FCF should exclude most income tax refunds, because most income tax refunds are nonrecurring due to the two-year net operating loss carryback limit under federal tax law.

On the other hand, because corporations make estimated income tax payments quarterly under a pay-as-you go system, income tax payments (or refunds) frequently result from transactions of prior or future periods. For valuation purposes, prospective after-tax FCF should include any income tax payments (or refunds) of past and future periods attributable to before-tax cash flows included in FCF of the current period that are expected to recur in future periods. That is, matching income tax effects against before-tax cash flows is important in deriving prospective after-tax FCF for valuation purposes. The objective here is to derive an estimate of prospective after-tax FCF that is most representative of after-tax FCF of future periods in order to more accurately estimate total shareholder value and total firm value.

Similarly, actual after-tax NCFO should also be adjusted to a prospective after-tax basis for analytical purposes, such as calculating cash flow interest coverage ratios. Again, the starting point to derive prospective after-tax NCFO is actual after-tax NCFO after allocating income tax payments (or refunds) for the period. The other adjustments are similar to those to derive prospective after-tax FCF.

To facilitate such adjustments, SFAS-95 should be amended to require disclosure of (1) gross income tax payments separate from gross income tax refunds; (2) income tax effects of individual investing and financing transactions, distinguishing between actual tax payments or refunds of the current period with those of past or future periods; and (3) a reconciliation of the income tax effects of individual investing and financing transactions with the net income tax payment or refund. SFAS-95 should also be amended to require disclosure of the reasons for any significant leads and lags between the actual income taxes paid or refunded and the expected income tax effects of these transactions.

D. Free Cash Flow for Valuation Purposes

Financial analysts use prospective FCF to estimate the value of a non-financial company.[118] For this purpose, it is useful to distinguish between valuation of the company as a whole and valuation of common stockholders' interest in the company. For valuing a non-financial company as a whole, prospective FCF should be cash flow available to all claimants, debt holders, preferred shareholders, and common shareholders, after operating expenses and income taxes. Accordingly, prospective FCF for valuing a non-financial company as a whole should be before after-tax net interest payments and dividends. (Net interest payments mean interest payments net of interest collections from parking excess cash balances.) For valuing the common stockholders' interest in a non-financial company,

[118] Neither the finance literature nor the bank management literature suggests using FCF to value financial companies. Accordingly, the discussion here is limited to using FCF to value non-financial companies. But the same general considerations might apply in using FCF to value financial companies.

prospective FCF should be cash flow available after all prior claims have been paid, including income taxes, net interest payments, preferred dividends, debt principal payments, and preferred stock principal payments if redeemable. For both purposes, prospective FCF should be adjusted to exclude cash flows that are not anticipated to recur in future periods, and to include cash flows that did not occur in prior periods but that are anticipated to occur in future periods, as discussed in the preceding section.

E. Classification Adjustments

An earlier discussion demonstrated that the cash flow statement classification of cash flows relating to many transactions differs across companies, often without full disclosure. Due to the absence of uniform classification rules and adequate disclosure requirements under extant GAAP, the cash flow statement classifications and NCFO, NCFI, and NCFF subtotals are not comparable across companies. Some companies include cash receipts (but not cash payments) relating to these transactions in NCFO, whereas they are more appropriately classified as investing or financing inflows, as discussed earlier. Users can make the NCFO, NCFI, and NCFF subtotals more comparable across companies by reclassifying these receipts as investing or financing inflows for analytical purposes.

Because almost all companies use the indirect method to derive NCFO, many material operating inflows and outflows are included in reported NCFO but are not reported as separate line items in the cash flow statement and not disclosed elsewhere in the annual financial report. However, sometimes these operating, investing, and financing flows can be estimated from the balance sheet, income statement, notes to the financial statement, or MD&A. On the other hand, material investing and financing activities should be reported as separate line items in the cash flow statement if they involve cash inflows and outflows, otherwise in the supplemental disclosures. Unfortunately, it becomes more difficult to estimate cash flows when there are business acquisitions and dispositions or the effects of foreign currency exchange rates are material.

Currently, most GAAP pronouncements address balance sheet and income statement reporting, not cash flow statement reporting. As a result, some companies report these transactions more fully in the balance sheet and/or the income statement than in the cash flow statement, whereas other companies provide information on these transactions in the notes to the financial statements or MD&A. Some companies disclose the effect of some of these transactions in the note reconciling statutory and effective income tax rates, from which users can estimate the effect of these transactions on income and cash flow.

For example, consider COLI inflows and outflows.[119] Because almost all companies use the indirect method to derive NCFO, many COLI inflows and outflows are included in NCFO but not as separate line items, and are not disclosed elsewhere in the annual financial report. Although material COLI inflows and outflows that are classified as investing and financing inflows and outflows should be reported as separate line items in the cash flow statement, very few companies report such items. Some companies report COLI amounts in the balance sheet or income statement, and other companies provide COLI information in the financial statement notes or the MD&A. Some companies disclose the effect of COLI in the note reconciling statutory and effective income tax rates, from which users can estimate the amount of COLI income. But these are disclosures or estimates of COLI net assets and income, not of COLI cash flows.

Due to the absence of uniform classification rules under extant GAAP, reported NCFO, NCFI, and NCFF subtotals are not comparable across companies with respect to COLI cash flows, as noted previously. Given the limited disclosures under existing GAAP, the easiest way for users to derive comparable NCFO, NCFI, and NCFF subtotals across companies is to reclassify any COLI receipts and payments from investing or financing to operating activities for analytical purposes. Thereafter, reported NCFO would include all COLI receipts and payments and would be comparable with respect to COLI cash flows for all companies. Presumably, analysts could subjectively assess the quality of NCFO, depending on the magnitude of net COLI inflows relative to cash generated from buying and selling goods and services. Companies with NCFO generated largely by COLI would have different risk characteristics and growth prospects than companies with NCFO generated largely by buying and selling goods and services. The COLI component would be estimated from the COLI disclosures in the MD&A and notes to the financial statements. Unfortunately, when provided, these disclosures usually are accrual accounting numbers, not cash flow numbers, so the COLI cash flow estimates would be rough. Comparable adjustments of NCFO, NCFI, and NCFF subtotals might be made for other transactions whose cash flow statement reporting varies across companies.

Of course, a more sophisticated analysis could be made if all companies disclosed the amounts and cash flow statement classifications of these transactions. Analysts could then derive comparable NCFO, NCFI and NCFF subtotals by reclassifying the cash inflows and outflows consistently across all companies.

[119] See also Section VII E.8, *Company-Owned Life Insurance*.

XI. Conclusions

The three-way cash flow statement as prescribed by SFAS-95 as amended represents a substantial improvement over the now defunct statement of changes in financial position as prescribed by APB-19. But the SFAS-95 cash flow statement is not as good as it should be, and a big disappointment for many report users who expected a more informative and less ambiguous statement. The statement should be improved in several ways.

First, SFAS-95 should be amended to prescribe the direct method together with a supplemental reconciliation of net income and NCFO. Reporting gross operating inflows and outflows under the direct method with a supplemental reconciliation of net income and NCFO is finer or more informative than reporting NCFO under the indirect method. To implement the direct method, accounting systems should be modified along the lines suggested by Bahnson et al (1996, p. 12), to routinely record gross inflows and outflows in nominal cash accounts, as discussed earlier; the patchwork after-the-fact analysis of deriving gross inflows and outflows indirectly is too complicated and prone to error.

Second, the classification rules of SFAS-95 are simplistic and wrought with internal contradictions, in part because they are applicable to both financial and non-financial enterprises. The classification rules should be revised to distinguish between financial and non-financial enterprises and to conform to the underlying economics of the business as discussed in the finance literature. In particular, for non-financial companies, SFAS-95 should be amended to classify all interest payments as financing outflows, because they arise from borrowing, a financing activity; and to classify purchases and sales of most short-term non-trading debt securities as financing flows, together with interest collections thereon, because they arise from parking excess cash balances, the opposite of borrowing, another financing activity. For financial companies, taking deposits and honoring withdrawals are the opposite of making and collecting loans; both involve transactions with customers, and both involve investing flows, whereas the interest payments on deposits and interest collections on loans are operating flows. Additionally, there are a host of other transactions that are subject to ambiguous or inconsistent classification rules under SFAS-95. These ambiguities and inconsistencies should be eliminated.

Third, income tax cash flows should be allocated among operating, investing, and financing activities so that (1) actual NCFO is uncontaminated by the income tax effects of investing and financing activities; actual FCF (if reported) is uncontaminated by the income tax effects of financing activities; and (3) actual NCFO, NCFI, and NCFF subtotals are reported on an after-tax basis. Allocating income taxes in the cash flow statement is contrary of the basic objective of SFAS-95 of

reporting only actual (as opposed to hypothetical) cash flows. But such a departure is necessary to enhance the usefulness of the NCFO, NCFI, and NCFF subtotals. Additionally, the income tax effects of individual investing and financing transactions should be disclosed, whether of the current, past, or future period, so that users could more accurately estimate prospective after-tax NCFO (and after-tax FCF) for analytical purposes.

Making these changes in cash flow statement format and classification might be unpopular with management because they involve more work, especially mandating the direct method cash flow statement. Additionally, these changes would reduce the flexibility of existing GAAP, whereby management can opportunistically choose how to report certain transactions in the cash flow statement to improve some key cash flow statement subtotal or line item. But these changes would go a long way to making the cash flow statement more transparent, informative, and useful, hence would enhance the creditability of financial reporting generally.

Report users should remember, moreover, that except for certain income tax flows and third-party inventory financings, the cash flow statement is a historical report of actual cash flows. For analytical purposes, especially for valuation purposes, the cash flow statement should be adjusted to a prospective basis. To estimate prospective after-tax NCFO (and after-tax FCF), report users should exclude cash flows that are not representative of past performance and/or not expected to recur in the future; and they include cash flows that are representative and/or expected to occur in the future that did not occur in the past. Report users should pay particular attention to cash flows relating to discretionary costs, structured transactions, and business acquisitions and dispositions that are not representative of past performance and/or not expected to recur in the future.

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Appendix A – Non-financial versus Financial Companies

The finance literature does not adequately distinguish non-financial companies, such as merchandise, manufacturing, or services companies, from financial companies, such as banks and investment houses. The distinction between non-financial and financial companies depends, in part, on whether customers purchase goods and services, as is true of non-financial companies; or are buyers or borrowers and sellers or depositors of money and financial assets, as is true of financial companies. Of course, some diversified companies have both non-financial and financial components; the management, financial reporting, and analysis of such diversified companies should be component by component.

Non-financial Companies

For non-financial companies, interest and dividend payments are more similar than dissimilar. They are paid for the use of debt and equity capital, respectively, hence both are financing outflows.

Additionally, acquiring financial assets (other than trade receivables) by non-financial companies differs substantially from acquiring tangible and intangible operating assets used in the business, such as inventory, plant, equipment, and patents. From a finance perspective, non-financial enterprises borrow or issue equity when they need cash, and usually acquire short-term debt securities when they have excess cash balances and seek interest revenue.[120] Accordingly, acquiring and disposing of short-term debt securities by non-financial companies is just the opposite of borrowing, hence is a (negative) financing activity, not an investing activity as under SFAS-95. Consistently, for non-financial enterprises, interest collections on short-term debt securities are financing inflows, not operating inflows as under SFAS-95, and not investing inflows, as some (e.g., Nurnberg, 1993, pp. 65-66) propose. For this reason, several financial analysis textbooks (see, e.g., Palepu et al., 2004, p. 5-24; and Penman, 2007, ch. 9-10) suggest deriving FCF by adjusting NCFO under SFAS-95 in part by adding back after-tax interest outlays net of interest collections.

Financial Companies

The finance literature does not typically address the distinctions among operating, investing, and financing decisions of financial companies such as banks and investment companies. The same is true of some specialized areas of finance, such as bank management. For example, three recent bank management textbooks (Gup & Kolari, 2005; Hempel & Simonson, 1999; and Rose & Hudgins, 2005) do not discuss these distinctions; additionally, they do not list the cash flow statement as a principal financial statement of banks. Indeed, according to Professor Benton E. Gup, Robert Hunt Cochrane/Alabama Bankers Chair of Finance at the University of Alabama, the distinction between investing and financing decisions is not relevant to banks; and bank analysts and regulators do not use cash flow statements of banks for analytical purposes.[121]

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[120] Non-financial companies do not normally acquire long-term debt securities and either short- or long-term equity securities just to invest excess cash balances in interest or dividend yielding securities; such investments are too speculative, and have too much price risk. On the other hand, non-financial companies sometimes acquire short- or long-term debt and equity securities to secure and/or maintain some business relationship with the investee; such investments have positive net present values, an essential characteristic of investing activities. From a finance perspective, outlays for such investments are investing outflows and dividend collections thereon are operating inflows, much as outlays for plant assets are investing outflows and the cash generated thereon are operating inflows.

[121] Telephone conversation with Benton E. Gup on 3 September 2005.

Gup & Kolari (2005, p. 117) note that the management of a bank involves daily decisions about making particular loans, about purchasing and selling securities, and about how to finance both; and that these decisions depend on the following:

(a) management expectations concerning future changes in interest rates;

(b) the composition of bank assets and liabilities; and

(c) the degree of risk bank management wants to assume.

The process of making such decisions is known as asset-liability management (ALM), and is discussed extensively in bank management textbooks (see, e.g., Gup & Kolari, 2005; Hempel & Simonson, 1999; and Rose & Hudgins, 2005). As the names suggest, asset management deals with determining the composition of a bank's assets, and might be viewed as the counterpart of investment decisions in the finance literature. Similarly, liability management deals with determining the composition of a bank's liabilities, and might be viewed as the counterpart of financing decisions in the finance literature. Unlike the typically long-term focus of investing and financing decisions in the finance literature, however, ALM has a short-term orientation. The traditional goal of ALM is to control a bank's net interest income with respect to interest rate risk and liquidity, often on a daily (or even more frequent) basis.

Because financial companies such as banks are in the business of lending and borrowing money, one could argue that their central operating activities include (1) purchasing and selling investments in debt and equity securities and, where applicable, (2) taking deposits and honoring withdrawals. Consistent with this viewpoint, outflows for purchases and inflows from sales of such investments would be operating flows included in both NCFO and FCF, as would any interest and dividend collections thereon. Additionally, where applicable, inflows from borrowing money (including taking deposits) and outflows for repaying amounts borrowed (including withdrawals of deposits) would also be operating flows included in NCFO and FCF, as would any interest payments thereon. Under this schema, both NCFO and FCF could be easily manipulated by voluntary actions of management. For example, both NCFO and FCF would increase (decrease) merely by selling (purchasing) trading or non-trading securities; similarly, both would increase (decrease) merely by increasing (decreasing) deposit liabilities by increasing (decreasing) interest rates paid thereon. Of course, financial companies would have few non-operating cash flows, and most of the cash flow statement classification issues addressed in this paper would be moot.[122] Additionally, consolidated NCFO and FCF metrics would lose significance to outside report users to assess firm value or performance whenever material financial company subsidiaries are included in the consolidated financial statements of non-financial parent companies.[123]

[122] As noted earlier, this was the viewpoint argued by many banks and other financial companies that initially sought to be exempt from the requirement to issue cash flow statements.

[123] This loss of significance of NCFO and FCF metrics presupposes full consolidation of the financial statements of financial subsidiary companies with the financial statements of their non-financial parent companies consistent with current generally accepted accounting principles (GAAP) under FASB Statement No. 94, *Consolidation of All Majority-owned Subsidiaries* (SFAS-94, 1987). Conceivably, this loss of significance might be mitigated, provided that non-financial parent companies prepared so-called one-line consolidated financial statements with financial subsidiaries consistent with practice prior to SFAS-94. However, one-line consolidations would require revision of SFAS-94, and is neither further contemplated nor proposed in this paper.

In order to meaningfully include financial company subsidiaries in full consolidated financial statements of non-financial parent companies, this paper must reject, or at least ignore, the arguments in the preceding paragraph. This paper must reject or at least ignore the argument that the operating cash flows of financial companies include those from (1) purchasing and selling trading and non-trading debt and equity securities, and, where applicable, (2) taking deposits and honoring withdrawals. Rather, this paper presupposes that, like non-financial companies, cash flow statements of financial companies are at least potentially useful to outside report users; and that they are also needed under existing GAAP to prepare meaningful full consolidated financial statements of subsidiary financial companies with their non-financial parent companies under existing GAAP. To do this, it is necessary to meaningfully classify the cash flows of financial companies as relating to operating, investing, and financing activities. However, contrary to SFAS-95, the same cash flow statement classification rules need not apply to both financial and non-financial companies.[124] Conceptually, the classification of cash flows for both financial and non-financial companies should be based on the distinctions among operating, investing, and financing decisions found in the finance literature. However, developing such distinctions for financial companies is tentative and somewhat arbitrary—hence are also somewhat speculative.

Therefore, this paper posits that for financial companies, extending and collecting (or selling) loans are investing activities, as are purchases and sales of non-trading debt and equity securities; these activities are expected to generate cash flows with positive net present values, an essential characteristic of investing activities. Accordingly, outflows for purchasing and inflows from selling non-trading debt and equity securities are investing flows, as are outflows for making loans and inflows from collecting or selling loans; as investing flows, they should be included in FCF but not in NCFO. On the other hand, purchases and sales of trading debt and equity securities by financial companies are operating flows, comparable to purchases and sales of inventories by non-financial companies, hence should be included in NCFO and FCF. Interest and dividend collections on loans as well as trading and non-trading debt and equity securities are also operating inflows of financial companies, much as rental collections are operating inflows of rental companies; accordingly, both should be included in both NCFO and FCF. So far, these classifications conform to those in SFAS-95.

Unlike SFAS-95, however, for financial companies, accepting deposits and honoring withdrawals are just the opposite of extending and collecting loans, hence are (negative) investing activities. Importantly, accepting deposits and honoring withdrawals are not financing activities of financial companies, contrary to SFAS-95: they involve transactions with entities functioning principally as customers rather than as creditors; they are significantly different from obtaining debt capital from bondholders and equity capital from stockholders. Rather, inflows for deposits accepted and outflows for withdrawals are (negative) investing flows and should be included in FCF but not in NCFO.[125] But as Penman (2007) notes, interest payments on deposits are operating outflows of

[124] In particular, as noted below, this paper argues that most interest payments are financing outflows of non-financial companies but operating outflows of financial companies; and that interest inflows from parking excess cash balances are negative financial outflows (i.e., financial inflows) of non-financial companies but operating inflows of financial companies.

[125] Alternatively, one might argue that accepting deposits from and honoring withdrawals by depositors are financing activities of financial companies, little different from borrowing from and repaying amounts to bondholders; in effect, depositors are the principal source of debt capital of financial companies. Consistent with this viewpoint, inflows for deposits accepted and outflows for withdrawals would be financing flows to be excluded from NCFO and most measures of FCF, as would interest payments on deposits. However, consistent with the traditional goal of controlling a bank's net interest income with respect to interest rate risk and liquidity, it makes no sense to include dividend and interest collections

financial companies, much as dividend and interest collections are operating inflows.[126] Consistent with the traditional goal of controlling a bank's net interest income with respect to interest rate risk and liquidity, it makes no sense to include dividend and interest collections, but not interest payments on deposits, in NCFO and FCF.

but not interest payments on deposits in NCFO. Similarly, it makes no sense to include cash flows from lending and investing activities in but exclude taking deposits and honoring withdrawals from FCF. This is one reason why this paper concludes that accepting deposits and honoring withdrawals are negative investment activities of financial companies. Additionally, they are significantly different from obtaining debt capital from and repaying amounts to bondholders. At the margin, of course, this paper assumes that the differences outweigh the similarities between, say, five year CDs and five year bonds.

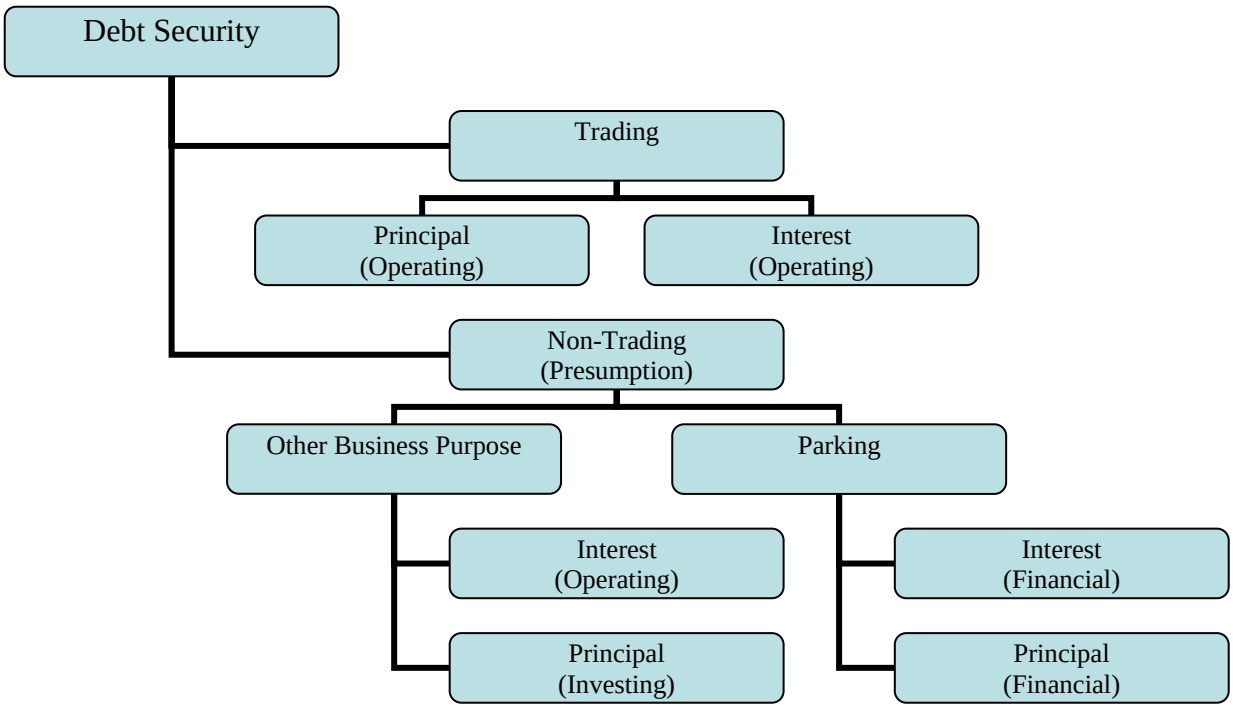
[126] White et al. (2005) also distinguish between interest and dividend collections of non-financial versus financial companies, but implicitly and somewhat differently. For analytical purposes, they (2005, p. 97) call for reclassifying net of tax interest and dividend collections as investing inflows. But they (p. 97, n. 32) suggest that interest and dividend collections are operating in nature "…if such investments assist in current or future operations."

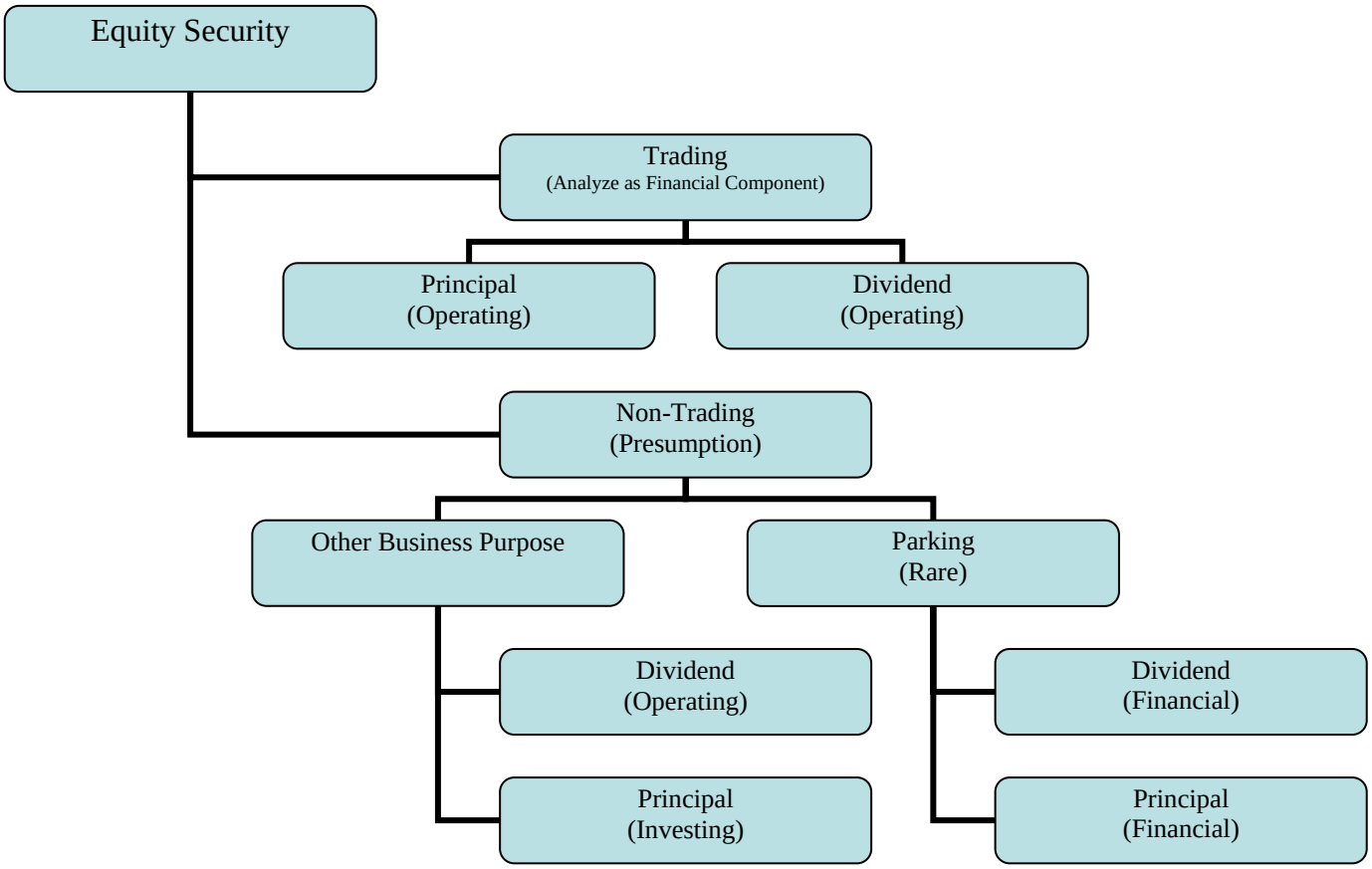
Appendix B – Table of Cash Flow Statement Classification Rules Addressed in this Paper

Issues	Existing Practice	Recommended
Non-financial versus Financial Companies	Same classification rules	Different classification rules
Derivation of NCFO	Direct or indirect method	Direct method
Uncapitalized Interest Payments – Bonded Debt	Operating outflows	Financing outflows
Uncapitalized Interest Payments – Other		
Non-financial Companies	Operating outflows	Financing outflows
Financial Companies	Operating outflows	Operating outflows
Capitalized Interest Payments	Investing outflows but ambiguous	Same as uncapitalized interest payments
Interest Collections – Non-financial companies		
Parking excess cash balances	Operating inflows	Financing inflows
Other	Operating inflows	Operating inflows
Interest Collections – Financial companies	Operating inflows	Operating inflows
Buying and Selling Trading Debt Securities – Non-financial and Financial Companies	Operating flows	Operating flows
Buying and Selling Non-trading Debt Securities – Non-financial Companies		
Parking excess cash balances	Investing flows	Negative financing flows
Other	Investing flows	Investing flows
Buying and Selling Non-trading Debt Securities – Financial Companies	Investing flows	Investing flows
Accepting deposits and honoring withdrawals – Financial Companies	Financing flows	Negative investing flows
Unamortized Discount on Bonded Debt	Four alternatives	Financing flows
Unamortized Premium on Bonded Debt	Four alternatives	Financing flows
Unamortized Discount on Bond Investment	Four alternatives	Face value investing inflows for original cost, operating inflows for original discount
Unamortized Premium on Bond Investment	Four alternatives	Interest receipts operating inflows up to interest earned, investing inflows for premium amortization
Debt Issuance Costs	Financing outflows	Financing outflows
Dividend Payments	Financing outflows	Financing outflows
Dividend Collections	Operating outflows	Operating outflows
Income Taxes Payments and Refunds	Operating outflows – income tax allocation prohibited (except windfall stock option)	Operating, investing, and financing flows – income tax allocation required
Income Tax Refunds	Report net or gross	Report gross
Installment Purchases and Sales of Inventory	Operating flows	Operating flows
Sales-Type Lease Receivables	Operating or investing inflows	Operating inflows
Installment Purchases of Plant Assets (principal)	Financing outflows	Investing outflows
Installment Sales of Plant Assets (principal)	Investing inflows	Investing inflows
Purchase and Sale of Rental Assets	Operating or investing flows	Operating or investing flows
Casualty Insurance Settlements	Operating inflows for inventory, business interruption; investing inflows for plant	Operating inflows for inventory, business interruption; investing inflows for plant

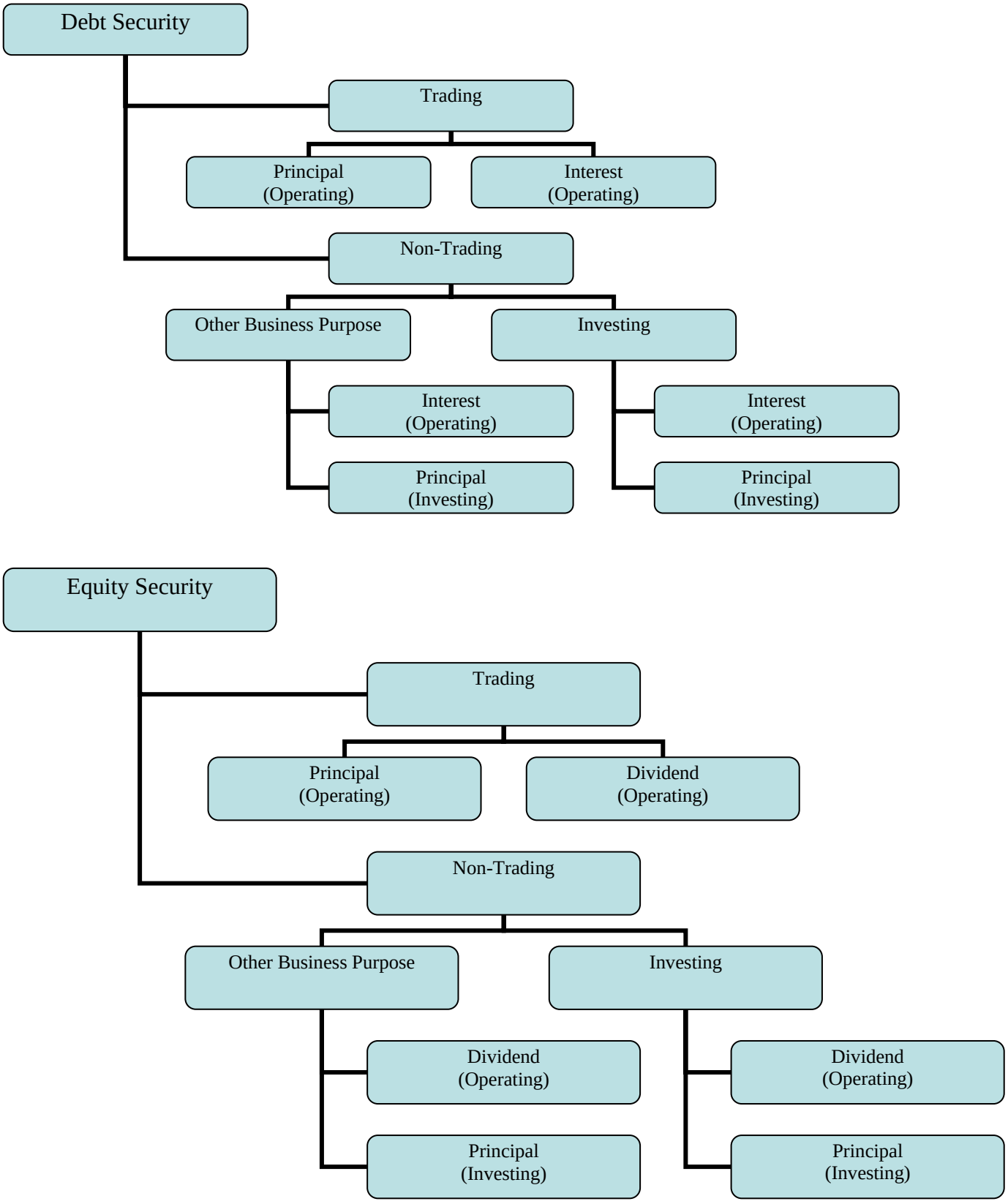
Issues	Existing Practice	Recommended
Software Development Costs	Operating outflows (if expensed); investing outflows (if capitalized)	Operating outflows (if expensed); investing outflows (if capitalized)
Film Development Costs	Operating outflows	Operating outflows (if expensed); investing outflows (if capitalized)
Company-Owned Life Insurance	Operating or investing flows	Operating or investing flows
Acquisitions and Dispositions of Businesses	Investing flows	Investing flows
Overdrafts	Operating or financing flows	Financing flows
Cash Equivalents	Operating flows	Operating flows
Notes Payable to Inventory Suppliers	Operating or financing outflows per SFAS-95; operating outflows per SEC	Operating outflows
Sales and Transfers Receivables	Operating or financing flows per SFAS-140	Operating or financing flows per SFAS-140
Payments to Settle Pension Liabilities	Operating or financing outflows per SFAS-95; operating outflows per SEC	Operating outflows
Sales Proceeds from Major Sale-Leaseback	Investing or financing inflows	Financing inflows
Repurchase Agreements	Operating or financing flows per SFAS-140	Operating or financing flows per SFAS-140
Reverse Repurchase Agreements	Operating or investing flows per SFAS-140	Operating or investing flows per SFAS-140
Hedging without significant financing element	Operating, investing, or financing flows	Operating, investing, or financing flows
Hedging with significant financing element	Financing flows	Separate into operating, investing, and financing flows

Appendix C – Classification of Cash Flows of Investments of Non-Financial Company





Appendix D – Classification of Cash Flows of Investments of Financial Company



Acknowledgments

This paper adapts materials authored or co-authored by its author and published (or to be published) as journal articles in *Accounting Forum*, © 2006 by Blackwell Publishing for the University of South Australia and adapted with permission; *Accounting Horizons* and *The Accounting Review,* © 1982 - 2004 by the American Accounting Association and adapted with permission; and in *The CPA Journal*, © 1990 - 2005 by the New York State Society of Certified Public Accountants and adapted with permission. This paper also adapts materials previously authored by its author and published (or to be published) by the Bureau of National Affairs (BNA) as a Portfolio, *The Cash Flow Statement*, © 2006 by BNA and adapted with permission. The author acknowledges that partial support for this paper has been received from BNA.

The author gratefully acknowledges the editorial assistance of Rachel Winston (Columbia University); and the helpful comments and suggestions of Aloke Ghosh (Baruch College), Peter Joos (Baruch College), Steven Lustgarten (Baruch College), David Morris (retired, formerly JP Morgan Chase), and especially Stephen H. Penman (Columbia University). Any errors, of course, are the responsibility of the author alone.

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