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Cash-Flow Reporting Practices for Customer-Related Notes Receivable: An Update

Executive Summary

In our April 2004 report, *Cash-Flow Reporting Practices for Customer-Related Notes Receivable*, we expressed the view that firms who reported as investing cash flow changes in customer-related notes receivable, including sales-type lease receivables, were reporting in a way that appeared to be inconsistent with generally accepted accounting principles. Recently, the Securities and Exchange Commission sent a letter to the CFOs of numerous firms who were following such practices. In the letter the SEC indicated that these firms were violating GAAP and it called for them to begin reporting such cash-flow activities as operating cash flow. This update reviews the points raised in our original report and highlights the names of several affected firms who we think could show material changes, including both sizable increases and reductions, in operating cash flow.

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The Georgia Tech Financial Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times our research may look at stock prices generally, though from a fundamental and not technical point of view.

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Ford Motor Co.	5
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Haemonetics Corp.	6
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Integrated Surgical Systems, Inc.	6
Nortel Networks Corp.	5
Paccar, Inc.	5
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Introduction

In April 2004 the Georgia Tech Financial Analysis Lab published a report titled, *Cash-Flow Reporting Practices for Customer-Related Notes Receivable*, a copy of which is available on our web site. The report was the subject of an article published in *The Wall Street Journal* by Jonathan Weil titled, "Cash Flow Never Lies – Or Does it?" In that report we identified several companies who were reporting in the investing section of the statement of cash flows changes in customer-related notes receivable, including sales-type lease receivables, arising from the sale of inventory. By reporting changes in these notes as investing cash flow, readers of their financial statements were left with the impression that the sales were collected at the time of sale, boosting operating cash flow, when in fact the notes may not have been collected.

In our earlier report we argued that firms who reported customer-related notes receivable as investing cash flow were reporting in a manner that appeared to be inconsistent with generally accepted accounting principles, in particular, SFAS No. 95, *Statement of Cash Flows*. We argued that SFAS No. 95 called for the reporting of changes in such notes receivable and sales-type lease receivables as operating cash flow in order to provide a more accurate measure of the amount of cash actually generated by operations.

SEC Takes Action

Recently the Securities and Exchange Commission sent a letter to the CFOs of companies who they believed may have presented changes in customer-related notes receivable as investing cash flow. In the letter, the SEC notes that such presentation is not in accordance with generally accepted accounting principles. The letter clearly calls for the firms to change their reporting practices, reclassifying changes in customer-related notes receivable to the operating from the investing section of the statement of cash flows. A copy of the letter can be found on the SEC website at: http://www.sec.gov/divisions/corpfin/guidance/cfcashflowlet0205.pdf.

Interestingly, in the letter the SEC does note that in changing their reporting practices, the affected firms would not be required to specifically reference the correction of an error, that is, the change would not be considered a restatement, provided the firms, among other things:

- Correctly presented the consolidated statements of cash flows for all periods presented,
- Indicated that the change in cash flow classification of customer-related notes receivable and sales-type lease receivables was the result of concerns raised by the SEC, and
- Provided other disclosures, such as a reconciliation of the amount previously presented for the affected cash flow line items and discuss the effect of these items in the liquidity and cash flow sections of MD&A.

Examples of Affected Companies

In our April 2004 report we provided exhibits that listed firms who reported as investing cash flow changes in customer-related notes receivable and customer-related sales-type lease receivables. The exhibits are reproduced as Exhibits 1 and 2 below.

As can be seen in the exhibits, in 2003 most affected firms would have reported lower operating cash flow had changes in customer-related notes receivable or sales-type lease receivables been reported in the operating section. Looking ahead to 2004 and beyond, whether changes resulting from the SEC's position on the matter results in lower or higher operating cash flow depends on whether the receivables in question increased or declined during the year.

Exhibit 1 Changes in Customer-Related Notes Receivable Reported as Investing Cash Flow

Company	**Year Ended**	**Cash Provided (Used) By Notes Receivable Reported as Investing**[a]	**Reported Cash Provided (Used) by Operating Activities**
Caterpillar, Inc.*	12/31/2003	*	$2,066,000
	12/31/2002	*	$2,366,000
	12/31/2001	*	$1,987,000
Deere & Company**	10/31/2003	$122,000	$1,535,700
	10/31/2002	($23,000)	$1,878,300
	10/31/2001	$141,000	$1,113,400
Ford Motor	12/31/2003	($2,878,000)	$20,195,000
	12/31/2002	($5,910,000)	$18,513,000
	12/31/2001	$10,932,000	$21,780,000
General Motors Corporation	12/31/2003	($4,058,000)	$7,600,000
	12/31/2002	($5,879,000)	$15,482,000
	12/31/2001	$11,413,000	$12,180,000
Harley-Davidson, Inc	12/31/2003	($133,958)	$935,553
	12/31/2002	($139,556)	$775,639
	12/31/2001	($111,380)	$750,204
Nortel Networks Corp.	12/31/2002	$31,000	($761,000)
	12/31/2001	($261,000)	$425,000
	12/31/2000	($480,000)	$946,000
Paccar Inc	12/31/2003	($27,800)	$818,700
	12/31/2002	($205,100)	$795,400
	12/31/2001	$45,500	$625,700
Textron, Inc.	1/3/2004	$14,000	$848,000
	1/3/2003	($318,000)	$640,000
	1/3/2002	$420,000	$989,000

Source: company filings with the SEC.

[a]Calculated change in customer-related or wholesale notes receivable reported as investing cash flow, net of amounts sold or securitized.

* Caterpillar, Inc. combined wholesale and retail notes receivable and did not provide separate detail of each. Accordingly, we could not determine the portion of the net change in these notes receivable that was for amounts due from the company's dealers.

** Amounts for Deere & Co. represent changes in wholesale notes receivable that are reported in investing cash flow as part of financing receivables. The company also reports other trade accounts and notes receivable in operating cash flow.

Exhibit 2 Changes in Sales-Type Lease Receivables Reported as Investing Cash Flow

Company	**Year Ended**	**Cash Provided (Used) by Lease Receivables Reported as Investing[a]**	**Reported Cash Provided (Used) by Operating Activities**
Boyd Bros Transportation	12/31/2003	$3,740	$10,366
	12/31/2002	$3,622	$12,265
	12/31/2001	$2,289	$13,419
Cisco Systems, Inc.*	7/26/2003	*	$5,240,000
	7/27/2002	*	$6,587,000
	7/28/2001	*	$6,392,000
Federal Signal Corp	12/31/2003	($5,118)	$75,377
	12/31/2002	$13,732	$88,350
	12/31/2001	($26,082)	$95,113
Haemonetics Corp.	3/29/2003	$384	$43,667
	3/31/2002	$2,153	$33,311
	3/31/2001	$4,597	$56,816
Integrated Surgical Systems, Inc.	12/31/2002	$46	($972)
	12/31/2001	$59	($237)

Source: Company filings with the SEC.
[a]Calculated change in sales-type lease receivables reported as investing cash flow.
*Cisco Systems, Inc. combined sales-type and direct-financing leases and reported the change in their total as investing cash flow.