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Customer-Related Notes Receivable and Reclassified Cash Flow Provided by Operating Activities

Executive Summary

In February, 2005, the Securities and Exchange Commission directed the Chief Financial Officers of various companies to begin reporting customer-related notes receivable, including sales-type lease receivables, as operating cash flow. The SEC's attention was drawn to this subject, in part, by our April 2004 report titled, *Cash-Flow Reporting Practices for Customer-Related Notes Receivable*. In that report we identified various companies who reported as investing cash flow changes in customer-related notes receivable and sale-type lease receivables. Following the SEC's action, these companies will now report changes in the balance of these receivables in the operating section of the statement of cash flows. This update reviews the impact of the SEC's action on the operating cash flows of the companies included in our original report.

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Georgia Tech Financial Analysis Lab

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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Introduction

In February, 2005 the Securities and Exchange Commission directed the Chief Financial Officers of various companies to begin reporting customer-related notes receivable, including sales-type lease receivables, as operating cash flow. The SEC's attention was drawn to this subject, in part, by on our April 2004 report titled, *Cash-Flow Reporting Practices for Customer-Related Notes Receivable*. In that report we identified various companies who reported as investing cash flow changes in customer-related notes receivable and sale-type lease receivables. It was our conclusion that this practice was inconsistent with generally accepted accounting principles. Following the SEC's action, the companies in question now report these customer-related notes receivable in the operating section of the statement of cash flows. This update reviews the impact of the SEC's action on the operating cash flows of the companies included in our original report.

Impact of Reclassification on Operating Cash Flow

In our April, 2004 report, we provided exhibits that listed firms who reported as investing cash flow changes in customer-related notes receivable. In that report we estimated the impact of a reclassification of these customer-related receivables to the operating section. In this follow up report we assess the actual impact on the companies' operating cash flows based on their 2004 10-K fillings[i,ii].

Exhibit 1: Impact Of Reclassification Of Customer-Related Notes Receivable On Cash Flows From Operating Activities.

Company	Year Ended	Reported Cash Provided (Used) by Operating Activities	Reclassified Cash Provided (Used) by Operating Activities	Change in Operating Cash Flow Due to SEC Action as Disclosed in Footnotes	Adjusted Cash Provided (used) by operating Activities	% change in operating cash flow
Caterpillar, Inc.**	12/31/2003	$2,066,000	($5,611,000)	($7,677,000)	($5,611,000)	(372%)
	12/31/2002	$2,366,000	($3,962,000)	($6,328,000)	($3,962,000)	(267%)
Ford Motor Co.	12/31/2003	$20,195,000	$17,280,000	($2,154,000)	$18,041,000	(11%)
	12/31/2002	$18,513,000	$11,739,000	($6,023,000)	$12,490,000	(33%)
General Electric Co.*	12/31/2003	$30,289,000	$29,229,000	($1,060,000)	$29,229,000	(3%)
	12/31/2002	$30,001,000	$28,766,000	($1,235,000)	$28,766,000	(4%)
General Motors Corporation	12/31/2003	$7,600,000	$2,956,000	($4,644,000)	$2,956,000	(61%)
	12/31/2002	$15,482,000	$11,075,000	($4,407,000)	$11,075,000	(28%)
Harley-Davidson, Inc.**	12/31/2003	$935,553	$662,652	($272,900)	$662,653	(29%)
	12/31/2002	$775,639	$545,562	($230,100)	$545,539	(30%)
Paccar, Inc.	12/31/2003	$818,700	$778,300	($40,400)	$778,300	(5%)
	12/31/2002	$795,400	$588,100	($207,300)	$588,100	(26%)
Textron, Inc.	1/3/2004	$848,000	$985,000	$127,000	$975,000	15%
	1/3/2003	$640,000	$676,000	$50,000	$690,000	8%

***** Impact of reclassification of customer related notes receivable is estimated based on the difference between the earlier reported cash provided by operating activities and the restated cash provided by operating activities.
****** Includes effects of collections on retained securitization interests.

Exhibit 1 highlights the impact of reclassification of customer-related notes receivable on operating cash flow for the companies identified in our original report. With double-digit percentage effects for most companies, it is noteworthy that reclassification had a material impact on reported operating cash flows for the companies listed.

Clearly the reclassification of customer-related notes receivable hit Caterpillar's cash flow from operating activities the hardest. The impact of reclassification was greatest for Caterpillar both in absolute dollars and in percentage terms. Caterpillar originally reported positive cash flows from operating activities of about $2.2 billion for 2003 and $2.4 billion for 2002. After reclassification, the company's operating cash flow was a *use* of cash of $5.6 billion for the year ended 2003 and a *use* of cash of $4 billion in 2002. The reclassification resulted in a reduction in reported operating cash flow of $7.7 billion, or a decrease of 372% in 2003 and $6.3 billion, or 263% in 2002. Though contributing to the company's negative cash flow effect was the classification as investing cash flow of collections on retained securitization interests.

Ford Motor and General Motors reduced their cumulative cash flows from operating activities for 2003 and 2002 by $8.2 billion $9.1 billion, respectively. Ford's reported operating cash flow decreased by 11% or $2.2 billion for the year ended 2003. In 2002 the decrease was 33% or $6 billion. For General Motors the decrease in cash flow from operating activities was $4.6 billion in 2003 and $4.5 billion in 2002.

General Electric Co. is another company that had to reclassify their cash flows from operating activities by over a billion dollars. General Electric was not included in our 2004 report because we were unable to reasonably estimate, from company-provided reports, the impact of customer-related notes receivable on operating cash flow. Moreover, the company's 2004 10K does not clearly indicate the impact of reclassification. General Electric reduced their originally reported cash flow from operating activities by $1.1 billion or 3% for the year ended 2003 and by 1.2 billion or 4% in 2002. It appears that these reductions in operating cash flow were due to the SEC mandate for change in the reporting of customer-related receivables.

Although the impact on Harley-Davidson, Inc and Paccar, Inc. in dollar terms were lower than the billions of dollar reclassifications required of other companies, both of the firm's cash flows from operating activities were significantly impacted by the restatement of customer-related notes receivable. Harley-Davidson's reported cash flow from operating activities decreased by 29% in 2003 and 30% in 2002. Paccar saw its operating cash flow decline by 5% and 26%, respectively, in 2003 and 2002.

Not all companies' cash flows from operating activities were negatively impacted by the reclassification of customer-related notes receivable. Textron, Inc. reported an increase in cash flow from operating activities of 15% in the year ended 2003 and an increase of 8% for the year ended 2002. This result is due to the fact that the balance in the company's notes receivable declined in both years as collections exceeded new credit sales.

Conclusion

The SEC's action to force change in the reporting of customer-related notes receivable was an important step. With the reclassification of cash flow related to these notes, the statements of cash flow for the affected firms now provide a clearer picture of the amount of cash generated by operations.

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[i] We were unable to include in this report the companies that we had identified in our original report as having classified sale-type lease receivables as investing cash flow because as of the date of this writing, most of the companies in question had not released their 2004 10Ks.

[ii] Deere & Company is not included in this report because the company released its latest 10K before the SEC letter.