COMPLIANCE WEEK

SEC Gives More Guidance On Cash Flow Corrections

By Tammy Whitehouse — March 21, 2006

Companies looking for direction on how to correct cash flow classifications now have more definitive guidance, following the Securities and Exchange Commission's decision last week to make a speech on the subject and accompanying slides more widely available.

The SEC has posted on its Web site the text of a speech delivered by Associate Chief Accountant Joel Levine at the December gathering of the American Institute of Certified Public Accountants. In that speech, Levine alerted accountants that the agency doesn't approve of how companies have been classifying cash flow related to discontinued operations. Until last week, the SEC had said the text of Levine's speech was unavailable.

Compliance Week broke the story on Tuesday, March 14. In February, the SEC communicated through the AICPA's Center for Public Company Audit Firms that companies could correct their errant classifications-without restating-if they did so in their next quarterly filing following Feb. 15, 2006. The SEC prescribed a method whereby companies could "revise" or "restate" cash flow classifications, but not call them "reclassified," without filing a full restatement of financial results.

That news has sparked considerable interest among accounting firms, although most are tight-lipped about how they are advising their audit clients to proceed. Six accounting firms, including the Big 4 firms, had no comment on the issue for this story, although Grant Thornton has said that it is advising all clients to review their cash flow statements for any errors they could correct while the SEC offers this one-time opportunity.

Three Acceptable Approaches

In Levine's original speech, he said SEC staff had been scrutinizing Financial Accounting Standard No. 95 Statement of Cash Flows and issuing more comment letters, leading to some restatements. The staff was specifically concerned about presentation for discontinued operations, dealer floor plan financing arrangements, and insurance claim proceeds, he said. "I would encourage you to evaluate carefully how you present these items in your cash flows statement in light of the remarks we will be making this morning," he said.

The numbers related to discontinued operations were getting bigger, Levine said, but that was "no surprise" because Statement No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets, issued in 2001, created "broad criteria" for what belongs in discontinued operations. The bigger numbers led the staff to become "acutely aware of a wide variety of ways in which those cash flows are being reported," he said.

Levine attributed the diversity of practice to Statement No. 144's silence on how to report cash flows associated with discontinued operations, even though "the notion of identifiable cash flows is integral to the model."

Leaning on the language in FAS No. 95 that requires cash flows to be classified as relating to either operating, investing or financing activities, Levine said the SEC staff would regard three approaches as acceptable:

1. Combine cash from discontinued operations with the cash from continuing operations within each of the three categories;
2. Separate the cash related to discontinued operations within each of the three categories; and,
3. Display cash from discontinued operations separately for operating, investing and financing activities near the bottom of the statement, just before "net increase or decrease in cash and cash equivalents."

Levine said the staff does not interpret Statement No. 95 to allow companies to lump operating, investing and financing cash flows from discontinued operations into a single line item, nor does it allow cash from discontinued operations to be dumped into the operating cash flow bucket.

Finally, Levine said, companies need to review their use of the indirect or reconciliation method to present operating cash flows. Many companies begin that calculation with the "income from continuing operations" while Statement No. 95 requires it to begin with "net income," he said. Levine also addressed some issues specific to car dealer financing, which has already led to a handful of restatements, and the classification of insurance proceeds, which should be based on the nature of the covered loss, not how the company plans to spend the money, he said.

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A Ripple Effect

Frank Scheuerell, a former staff member at the Financial Accounting Standards Board and now an accountant at Callaway Partners, which made its mark working on the HealthSouth restatement, says companies developed different ways of classifying cash flows from discontinued operations because of different interpretations of the requirements and options in Statements No. 95 and 144.

Scheuerell

"Before the AICPA conference, many believed that neither statement required a company to set out cash flows relating to discontinued operations separately in the statement of cash flows," he explains. "However, many believed a company could elect to do so. Many companies elected to do so because they believed separating cash flows from continuing and discontinued operations provides users with a clearer picture as to its cash flows attributable to its ongoing operations."

Scheuerell says companies have increased their disclosures related to discontinued operations because Statement No. 144 added new items to the category. He also said the SEC's path to issuing the cash flow classifications guidance-via a speech and a communiqué to a professional group-is meant to circumvent the time-consuming process of issuing more official guidance. "It's the quickest way to get information out there" without the chores of drafting documents and exposing them for review and comment.

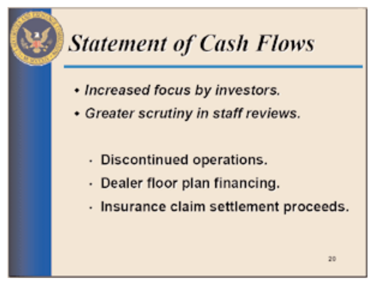
Mulford

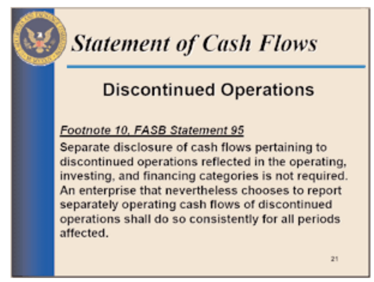
Charles Mulford, director of the Georgia Tech Financial Analysis Lab, says the spotlight on cash flow classifications may be creating a ripple effect into other presentations on the cash flow statements. General Motors said last week it will restate results back to 2000, at least in part due to cash flow classifications at the residential mortgage subsidiary of GMAC. GM said the problem relates to classifications of cash flows from certain mortgage loan transactions as cash flows from operations, instead of cash flows from investing activities. Video rental giant Blockbuster recently restated to correct how the company classifies purchases of movies for its rental library, an issue that rings familiar to Levine's remarks about financing arrangements at car dealerships. Loews Corp. also recently restated to correct classifications of cash flow from investments classified as trading securities.

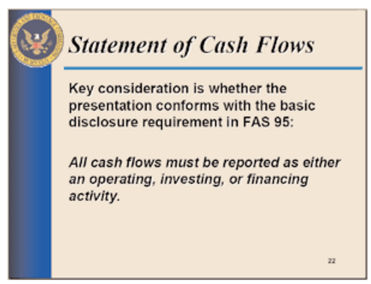
Mulford notes that Blockbuster's and Loews' problems differ from those the SEC highlighted in the December speech or the CPCAF alert. Still, he says, "I do think that all of the cash flow-related restatements are the result of a newfound attention of the SEC on the importance of cash flow classification."

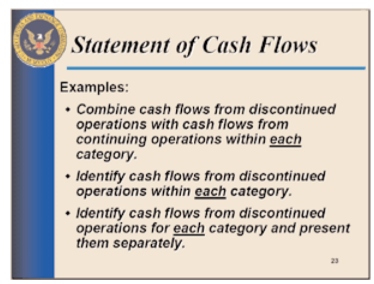
CPCAF director Lillian Ceynowa says identifying how many or what kind of companies will revise classifications following SEC's call for corrections is not easy. "It's difficult to characterize because it's all facts and circumstances," she says. Each company's management, audit committee and auditors will review its historic filings and determine how to proceed.

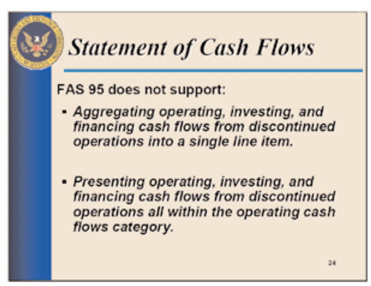
The "screen grabs" below are from the presentation mentioned at left, "Current Developments In The [SEC] Division Of Corporation Finance," delivered at the National Conference On Current SEC & PCAOB Developments, Dec. 6, 2005. The relevant section, titled "Statement Of Cash Flows," can be found on slides 20 through 33:

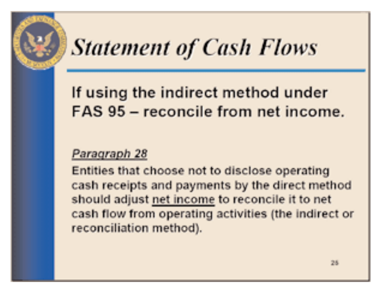












Source
"Current Developments In The [SEC] Division Of Corporation Finance" (SEC, Slides 20-33)
http://www.sec.gov/news/speech/slides120605jl.pdf