

April 16, 2004

Wall Street Journal

TRACKING THE NUMBERS

## Outside Audit - 'Cash Flow Never Lies' -- Or Does It?

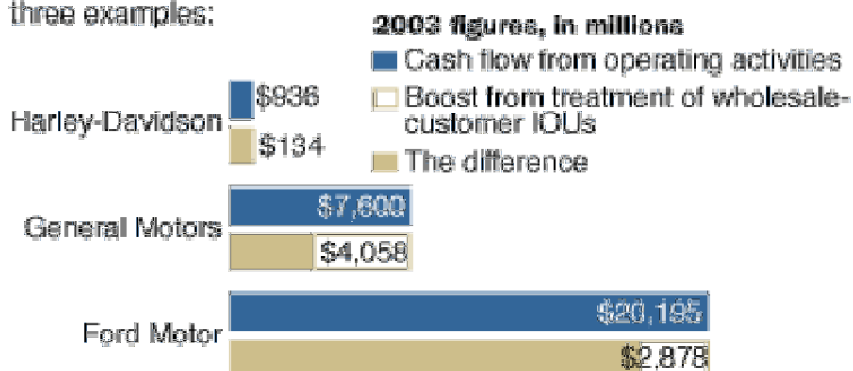
One Company's Investment Is Another's Core Operation;  
Tripping on the Footnotes

By JONATHAN WEIL Staff Reporter of THE WALL STREET JOURNAL

It remains an article of faith among many investors: Earnings can be faked, but cash flow never lies.

### FOLLOW THE MONEY

For accounting purposes, some manufacturers with captive finance subsidiaries treat cash flows from customer IOUs as part of their investing activities. In years when those IOUs are growing, the result is a boost to cash flow from operating activities. Below, three examples:



Source: Georgia Tech Financial Analysis Lab

The old saw gets it about half right -- the first half, specifically.

For as long as companies have published cash-flow statements, investors have used them to gauge the

credibility of earnings. The most closely watched portion of these reports is the part called cash flow from operating activities. If a company shows strong earnings but generates little cash from its core operations, it could be a warning sign that the earnings are illusory. Conversely, many investors take comfort in the quality of a company's earnings if they also see robust operating cash flow.

But not all operating cash flow is created equal, as a new report by the Georgia Tech Financial Analysis Lab shows. Part of the problem lies in vaguely written accounting rules

for cash-flow statements that give conflicting guidance on what qualifies as operating activities and what should be relegated to the other two sections on the cash-flow statement: investing activities and financing activities.

Customer-related cash flows generally are supposed to be presented as part of operating activities, while cash flows related to loans are supposed to be part of investing activities. So what to do with customer-related loans? Different companies often take different approaches to the same kinds of items.

Consider the issue of "vendor financing" and customer IOUs, which are the focus of the new report, written by Georgia Institute of Technology accounting professor Charles Mulford. Many companies lend their customers money to buy their products. Usually, the initial accounting is fairly simple. Revenue is recorded. Customer receivables go up. Inventory goes down. The company's operating cash flow remains unchanged.

Except that isn't how everybody does it.

Take the automotive industry. When Ford Motor Co. or General Motors Corp. lends money to dealers so they can buy wholesale inventory, the auto manufacturers recognize revenue on the sales. But they classify the loans as part of their investing activities. The result: Operating cash flow gets a boost before the loan is collected -- and it stays that way, even if the dealer later fails to pay what it owes. Harley-Davidson Inc., the motorcycle maker, uses the same practice.

All this can be pieced together from the numbers in the companies' footnotes. But to unsuspecting investors, the

companies' operating cash flows may look stronger than they really are, Mr. Mulford cautions, though he stresses that he isn't accusing anyone of violating any rules.

GM, Ford and Harley say they're simply following the Financial Accounting Standards Board's rules for cash-flow statements. The dealer loans, called "notes receivable," are made by captive finance subsidiaries, such as Ford Motor Credit Co. or General Motors Acceptance Corp. Therefore, they say, these notes must be treated as part of investing activities on the parent companies' consolidated cash-flow statements.

A Ford spokesman says the company's practice is "in accordance with generally accepted accounting principles," but he declines to discuss specifics. GM spokeswoman Sheri Woodruff says, "Because [the cash] flows from and through GMAC, we believe it makes sense to categorize it as an investing activity."

Harley's chief accounting officer, James Brostowitz, says, "We've made the decision that once the finance subsidiary takes hold of the receivable, it belongs to that segment."

Compare these practices with the approach at Navistar International Corp., which makes commercial trucks and school buses. Navistar also uses a captive finance subsidiary to finance its dealers' inventory purchases. The finance subsidiary shows the loans as part of investing activities on its own cash-flow statements. But when Navistar reports consolidated results, it reclassifies the receivables as part of operating cash flow.

"At the end of the day, we define ourselves as a manufacturing company with a finance subsidiary," rather

than the other way around, says Mark Oberle, Navistar's director of investor relations. "That sale and the associated change in receivables would be considered cash flow from operations, because it's part of our core business."

Mr. Mulford opines that Navistar's approach is the superior one. As for the other companies, "by including these notes in the investing section of the cash-flow statement at a time when these notes are growing, you end up with a materially higher operating cash flow number," Mr. Mulford says. "And that's what can mislead an investor." To be sure, the practice cuts both ways. When notes are shrinking, that can result in a drag on operating cash flow for companies that treat them as part of investing activities.

For 2003, Ford reported \$20.2 billion of cash flow from operating activities. Using data from the footnotes in Ford's financial statements, Mr. Mulford calculates that the figure would have been \$2.9 billion lower had the auto maker classified customer-related notes receivable as part of operating activities, rather than investing activities. GM's \$7.6 billion of operating cash flow would have been \$4.1 billion lower, he estimates, while Harley's \$935.6 million of operating cash flow would have been \$134 million lower.

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