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The distorting effects of acquisitions and dispositions on net operating cash flow

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Abstract

The cash flow statement is the third principal financial statement in a corporate financial report. It presents the cash inflows and outflows for the period, together with certain net cash flow subtotals, foremost being net cash flow from operating activities (henceforth NCFO). Under the cash flow statement classification rules of both the Financial Accounting Standards Board (FASB Statement No. 95, *Statement of Cash Flows*, 1987, henceforth FASB-95) and the International Accounting Standards Board (IASB Standard No. 7, *Statement of Cash Flows*, 1992, henceforth IASB-7), NCFO may increase directly as a result of business acquisitions and dispositions (henceforth acquisitions and dispositions, respectively), although the acquisitions and dispositions themselves are ostensibly reported in the cash flow statement as investing activities. Examples from annual financial reports suggest that this potential distortion of NCFO may be substantial. In general, however, required disclosures do not make transparent these potentially distorting effects on NCFO, especially when there are many acquisitions or dispositions or the disclosures are not timely.

These potentially distorting effects are important because they may impair the usefulness of NCFO in valuation models of the firm as well as in loan covenants and management compensation plans; they may also impair the reliability of investment decisions and empirical research findings based on NCFO. There is some anecdotal evidence that management manages NCFO, often with the acquiescence (if not encouragement) of institutional stockholders and sell-side analysts. Acquisition and disposition transactions provide management with another means of managing NCFO. Suggestions are offered to make the cash flow statement more transparent with respect to acquisitions and dispositions.

Keywords: Cash flow statement; Business combinations; Acquisitions; Dispositions; Transfer of assets and liabilities

Together with the balance sheet and income statement, the cash flow statement is one of three principal financial statements in a company's financial report to stockholders. Under classification

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rules of both the Financial Accounting Standards Board (FASB-95, 1987) and the International Accounting Standards Board (IASB-7, 1992), cash flows are classified as relating to operating, investing, or financing activities, and net cash flow subtotals are presented for each of these three activities (henceforth NCFO, NCFI, and NCFF, respectively). The subtotal of greatest interest to most report users is usually NCFO.

Under FASB-95 and IASB-7, operating cash flows include collections from sales and payments for purchases of goods and services. Investing cash flows include payments to acquire and proceeds from disposals of productive assets, including business acquisitions and dispositions (henceforth acquisitions and dispositions). Financing cash flows include proceeds from issuing debt or equity securities and from other short- or long-term borrowings; and payments to reacquire or retire equity securities, repay amounts borrowed, and dividends.

1. Known classification problems

According to Nurnberg (1993, pp. 61–65), the three-way classification of cash flows is loosely based on the finance literature, but certain modifications result in inconsistent or ambiguous classifications of certain cash flows. As a result, NCFO frequently includes cash flows from investing and financing activities. Similarly, NCFI and NCFF frequently exclude certain cash flows attributable to investing activities and financing activities, respectively.

Many of these classification issues and their distorting effects on NCFO have already been documented in the literature on the cash flow statement. For example, Stewart, Ogorzelec, Baskin, and Duffy (1988, pp. 7–8), Nurnberg and Largay (1998, pp. 411–412) and Vent, Cowling, and Sevalstad (1995, pp. 88–96) note that although they could be treated as elements of NCFO, premiums or discounts on bond investments and bonded debt could be treated as elements of NCFI and NCFF, respectively. Munter (1990, pp. 54–55) notes that two companies with identical interest or lease payments will report different amounts for NCFO if one company capitalizes interest or lease payments and the other company does not. Alderman and Minyard (1991, pp. 20–21) note variations in the cash flow statement classification of bank overdrafts depending on balance sheet treatment; changes in overdrafts are included in NCFO if overdrafts are netted against deposit accounts with positive balances, but are included in NCFF if overdrafts are treated as borrowings. Munter and Moores (1992, pp. 52–55) note several variations in cash flow statement classification of interest payments when total interest cost differs from total interest paid and some interest cost is capitalized. Nurnberg (1993, pp. 67–69) notes that because income tax payments are operating cash flows under FASB-95, NCFO includes the income tax effects of certain gains and losses relating to investing or financing activities; as a consequence, NCFO is contaminated by the tax effects of gains and losses relating to these investing and financing activities.[1] Nurnberg and Largay (1996, pp. 123–136) note variations in the cash flow statement classification of hedging activities, sale-leaseback transactions, purchase and sale of rental assets, loan securitizations, and repurchase/reverse repurchase agreements. Finally, Nurnberg (2004, pp. 113, 116) identifies four

[1] A required exception under FASB-95 (and a permitted exception under IASB-7) is the tax benefit of the windfall stock option deduction. (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 FASB-95 as amended by FASB Statement 123(R), "Share-Based Payments" (FASB-123(R), 2004, para. 68), the imputed income tax benefit of the windfall stock option deduction is reported as a financing inflow. Before this amendment, FASB-95 treated it as a reduction of operating outflows for income taxes, usually buried in the indirect method derivation of NCFO. Accordingly, NCFO will be less than formerly. So will performance compensation based on NCFO.