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Effects of cash flow statement reclassifications pursuant to the SEC's one-time allowance

Dana Hollie [a,*], Curtis Nicholls [b], Qiuhong Zhao [c]

[a] E.J. Ourso College of Business, Louisiana State University, Baton Rouge, LA 70803, United States
[b] School of Management at Bucknell University, Lewisburg, PA 17837, United States
[c] School of Accounting at the University of Missouri at Columbia, Columbia, MO 65211, United States

A B S T R A C T

In February 2006, the Securities and Exchange Commission (SEC) announced a one-time opportunity for firms with misclassified cash flow items to correct these errors without issuing an official restatement. To assess the impact of these reclassifications, we determine the types of firms affected by this allowance and the types of reclassifications in the operating, investing, and financing categories of the cash flow statement. We find that, consistent with the SEC's concerns, firms overstated net operating cash flows and understated net investing cash flows, thereby misrepresenting cash flows. In addition, the most frequent line-item reclassifications echo the SEC's concerns about the presentation of discontinued operations and dealer floor plan financing arrangements. Insurance claim proceeds and beneficial interests in securitized loans, however, appear less problematic than the SEC expected. Overall, our findings indicate that the SEC's plan was relatively successful and, for firms that took advantage of the allowance period, these cash flow restatements only exerted a marginally negative effect in the capital market.

1. Introduction

In February 2006, the Securities and Exchange Commission (SEC) announced a one-time allowance for firms with erroneous cash flow statement classifications to correct these misstatements without officially restating their cash flows.[1] To assess the impact of this allowance, we determine the types

* Corresponding author. Tel.: +1 225 578 6222; fax: +1 225 578 6201.
E-mail address: danahollie@lsu.edu (D. Hollie).

[1] The terms "cash flow restatement" and "cash flow reclassification' are used interchangeably throughout this paper.

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of firms and industries affected and the reclassifications occurring within the operating, investing, and financing categories of the cash flow statement. We then identify the line-item classifications in the categories most affected by the reclassification process and assess whether these revised disclosures provided new information to capital markets.

Although the SEC had serious concerns about the proper classification of cash flows prior to this period, the actual prevalence of these misclassifications was unknown. For example, as emphasized by Lillian Ceynowa, director of the Center for Public Company Audit Firms (CPCAF), "no one—not auditors, academics, or the SEC—seems to know exactly how many companies misclassified cash flows from discontinued operations. The problem, however, isn't limited to any particular industries or company size" (as quoted by Leone, 2006).[2] Therefore, examining these cash flow reclassifications is important because it allows regulators, auditors, investors, practitioners, and academics to understand the extent and significance of cash flow misclassifications. In particular, even though recent accounting scandals primarily involved earnings manipulation—leading financial statement users to embrace cash flow metrics—cash flows can be manipulated in a similar fashion. The SEC has recently seen an increase in misclassifications on cash flow statements (Levine, 2005), a presentation problem affecting firm transparency. An appropriate presentation allows investors a better understanding of the factors that contribute to sustainable operating cash flows. Misclassifications affect investors' efficient use of cash flow information when making investment and financing decisions, as well as their ability to predict future cash flows.

Auditors must be aware of the new focus that financial statement users place on cash flows and adjust their work accordingly. For instance, an auditor's evaluation of a firm's internal controls of cash flow could enhance the quality of financial reporting. Although some of the misclassification issues identified in our study differ from those highlighted in the SEC's CPCAF alerts, the related restatements apparently resulted from the SEC's increased scrutiny of cash flows. For example, General Motors, Inc. responded to the SEC's concerns by restating its cash flows for 2002, 2003, and 2004 and significantly reducing its operating cash flows by $3 billion, $6 billion, and almost $4 billion, respectively.

1.1. Background of the SEC's one-time allowance period

At the 33rd AICPA National Conference on Current SEC and PCAOB Developments (December 2005), Joel Levine, an associate chief accountant at the SEC, noted an increase in misclassifications in the Statement of Financial Accounting Standard No. 95, *Statement of Cash Flows* (SFAS 95; 1988). He also pointed out that the presentation formats used by some companies were inconsistent with the SFAS No. 95 requirement that companies classify cash flows as operating, investing, or financing. Given the relative newness of this SFAS statement in the context of financial disclosure, some misclassifications were to be expected.[3]

Within the accounting profession and among regulators, the debate about the proper format of cash flow statements may have contributed to classification errors. When finalizing the reporting requirements for cash flow statements, the Financial Accounting Standards Board (FASB) included interest-related cash flows in the operating section. In contrast, the AICPA suggested reporting interest payments as a non-operating cash flow item. Prior research, indicates that the format of cash flow statements may be important to regulators, auditors, and other users of financial statements (Klammer and Reed, 1990; Bahnson et al., 1996; Drtina and Largay, 1985).

Shortly after Levine's February 2006 speech the SEC, through the AICPA, stated its position on the reclassification of items in cash flow statements (CPCAF Alert #90). The SEC allowed companies to correct their errant classifications within their quarterly filings immediately following February 15, 2006, without any official restatement. Firms were also advised to revise their cash flow statement presentations by restating prior periods as corrections of errors rather than as restatements. This permitted companies to revise or alter cash flow classifications without filing a full restatement of their financial results (Whitehouse, 2006).

[2] The Center for Public Company Audit Firms is a unit of the AICPA and works closely with regulators to disseminate rule interpretations.

[3] Prior to the issue of SFAS No. 95 in 1988, the statement of cash flows was not required for SEC filings.