

Inconsistencies and Ambiguities in Cash Flow Statements Under FASB Statement No. 95

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SYNOPSIS: Under FASB Statement No. 95 (SFAS-95), cash receipts and cash payments are classified in the cash flow statement as resulting from investing, financing, or operating activities. This three-way classification is loosely based on the finance literature, but important modifications result in inconsistent or ambiguous classifications of certain cash flows. For this reason, reported cash flow from operating activities frequently includes cash flows from investing and financing activities. Similarly, reported cash flows from investing activities and financing activities frequently exclude certain cash flows properly attributable to them.

This paper examines the distinctions among operating, investing, and financing activities under SFAS-95, and compares them with similar distinctions in the finance literature. It identifies several inconsistencies and ambiguities in the three-way classification of cash flows under SFAS-95. More specifically, this paper demonstrates that the three-way classification and the ambiguous presentation of third-party financing transactions under SFAS-95 results in reporting similar cash flows differently and different cash flows similarly, just the opposite of the desired characteristic of financial reporting. Additionally, the required classification of interest and dividend collections and interest and income tax payments as operating cash flows is shown to result in contaminating operating cash flow with certain effects of investing and financing activities, and may result in a peculiar if not counterintuitive presentation of the retirement of bonded debt originally issued at a discount. Finally, this paper demonstrates that the disclosure requirements for noncash investing and financing transactions are ambiguous.

By highlighting these inconsistencies and ambiguities of SFAS-95, it is hoped that readers will be more aware that the amounts reported as cash flow from operating, investing, and financing activities do not reflect all of the cash consequences of these activities and, accordingly, that the reported amounts should not be used in decision models without adjustment. It is also hoped that the FASB will be persuaded to amend SFAS-95 to eliminate the ambiguities and more closely conform the classification rules to the finance literature, so that the information in the cash flow statement more closely conforms to the decision models and therefore becomes more useful to report users.

Data Availability: All data used in this study are public domain.

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FASB Statement No. 95 (SFAS-95) requires firms to provide a cash flow statement for each period for which results of operations are provided. The cash flow statement explains the change during the period in cash and cash equivalents, and classifies cash receipts and cash payments as resulting from investing, financing, or operating activities (SFAS-95, paras. 7, 14). This latter requirement represents a major change from APB Opinion No. 19 (APBO-19), which permitted but did not require a three-way classification of funds flows in the old statement of changes in financial position.

Although the three-way classification of SFAS-95 is loosely based on the finance literature, certain modifications result in inconsistent or ambiguous classifications of certain cash flows. Accordingly, reported cash flow from operating activities under SFAS-95 frequently includes cash flows from investing and financing activities. Similarly, reported cash flows from investing activities and financing activities frequently exclude certain cash flows properly attributable to them.

Many of these classification issues applied to the old statement of changes in financial position under APBO-19, and were extensively documented in the literature (see, e.g., Nurnberg 1983; Drtina and Largay 1985; Ketz and Largay 1987). Although SFAS-95 substantially enhances uniformity in funds concept and statement presentation relative to APBO-19, the fact that some of these classification issues remain unresolved under SFAS-95 is not widely recognized and understood by report users.

PURPOSE OF PAPER

This paper examines the distinctions among operating, investing, and financing activities made in SFAS-95, and compares them with similar distinctions in the finance literature. It identifies several inconsistencies and ambiguities in this three-way classification and in the disclosure requirements of SFAS-95, and demonstrates the following:

- (1) The required three-way classification under SFAS-95 results in reporting similar

cash flows differently and different cash flows similarly, just the opposite of the desired characteristic of financial reporting to report similar things similarly and different things differently.

- (2) The classification of interest and dividend receipts and interest payments as operating cash flows under SFAS-95 results in contaminating reported cash flow from operating activities with the interest and dividend effects of investing and financing activities. It also produces a peculiar if not counterintuitive presentation in the cash flow statement of the retirement of bonded debt originally issued at a discount.
- (3) The classification of income taxes as operating cash flows under SFAS-95 contaminates reported cash flow from operating activities with the tax effects of gains and losses relating to investing and financing activities.
- (4) The requirement to disclose noncash investing and financing transactions under SFAS-95 is ambiguous.
- (5) The required presentation of third-party financing transactions under SFAS-95 is also ambiguous and results in reporting similar cash flows differently and different cash flows similarly.

TRICHOTOMY IN FINANCE LITERATURE

The finance literature notes that investing and financing decisions are interrelated (see, e.g., Brealey and Myers 1984, 443-61; Solomon and Pringle 1980, 441-42), and that both are related to operating decisions (see, e.g., Brealey and Myers 1984, 229, 701; Solomon and Pringle 1980, 142, 315). Nevertheless, the finance literature posits that, for many purposes, it is useful to distinguish between investing decisions and financing decisions (see, e.g., Brealey and Myers 1984, 101, 279; Solomon and Pringle 1980, 362, 435-41), and to separate investing and financing decisions from operating decisions (see, e.g., Solomon and Pringle 1980, 315).

Operating decisions address questions such as which goods and services to sell, which goods and services to purchase, which employees to hire and at what compensation levels, which facilities to rent, and so forth.

Investing decisions address such questions as how much a firm should invest and what specific assets a firm should invest in. From the finance perspective, all asset acquisition decisions are investing decisions and are fundamentally alike, whether involving long-term assets such as plant and equipment, or short-term assets such as inventories and trade receivables. For analytical purposes, however, long-term asset acquisition decisions are usually viewed as investing decisions, whereas short-term asset acquisition decisions are usually viewed as working capital management decisions.

Financing decisions deal with the volume and structure of a firm's financing, including whether the cash required for investment should be generated by internal or external sources and, if the latter, whether by debt or equity securities. From the finance perspective, all borrowing decisions are fundamentally alike, whether involving long-term liabilities such as mortgage and bonded debt or short-term liabilities such as bank loans and trade payables. For analytical purposes, however, long-term borrowing decisions are usually viewed as financing decisions, whereas short-term borrowing decisions are usually viewed as working capital management decisions.

Comparing the three-way classification of SFAS-95 to the finance literature emanates from the decision usefulness orientation of financial reporting. Because the objective of financial reporting is to provide information that is useful in credit and investment decisions (see SFAC-1, 1978, paras. 30-32), cash flow statements should provide information needed for credit and investment decision models. Many of these decision models are specified in the finance literature and use financial ratios. For example, Weston and Copeland (1992, 205) suggest certain financial ratios which use operating cash flow in

either the numerator or denominator. The usefulness of these ratios as well as cash flow information generally should be enhanced by classifying cash flows in the cash flow statement as they are classified in the finance literature.

TRICHOTOMY UNDER SFAS-95

Under SFAS-95, cash flows are classified as relating to operating, investing, or financing activities.

Operating Activities

In SFAS-95, the FASB defines (para. 21) operating activities as a residual category to include all transactions and events other than investing and financing activities. It notes that operating activities generally relate to producing and delivering goods and providing services, and that the cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

Under SFAS-95, operating cash inflows include interest and dividend collections on debt and equity securities of other entities, customer collections from the sale of goods and services, and all other receipts not defined as investing or financing inflows, such as supplier refunds, collections on lawsuits, and most insurance proceeds. Operating cash outflows include interest payments (unless capitalized), payments for inventories, payments to employees, payments to suppliers of other goods and services, payments to governments for taxes, duties, fines, and other fees, and all other payments not defined as investing or financing outflows, such as customer refunds, payments under lawsuits, and charitable contributions.

Investing Activities

SFAS-95 defines (para. 15) investing activities to include (1) making and collecting loans and (2) acquiring and disposing of debt or equity instruments and plant assets. Thus, investing cash outflows include payments to make or acquire loans, payments to acquire debt or equity securities of other entities, and

payments to acquire plant assets. Investing cash inflows include receipts from collecting or disposing of loans, receipts from sales of debt or equity securities of other entities, and receipts from sales of plant assets.¹ Note that under SFAS-95, interest and dividend collections are classified as operating inflows, not investing inflows.

Financing Activities

SFAS-95 defines (para. 15) financing activities to include (1) obtaining resources from owners and providing them with a return on, and a return of, their investment; (2) borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and (3) obtaining and repaying other resources obtained from creditors on long-term credit. Under SFAS-95, financing cash inflows include proceeds from issuing debt or equity securities, and proceeds from other short- or long-term borrowings. Financing cash outflows include dividend payments, outlays to reacquire or retire equity securities, and repayments of amounts borrowed. Note that under SFAS-95, interest payments are classified as operating outflows, not financing outflows.

EVALUATION OF SFAS-95 TRICHOTOMY

The rationale offered in SFAS-95 (paras. 55, 81) for the three-way distinction among operating, investing, and financing cash flows is that investors and creditors consider the relationships among certain cash flows to be important to their analysis of financial performance, and that classifying cash flows as operating, investing, and financing facilitates the evaluation of significant relationships within and among these basic activities. This classification, the FASB notes (SFAS-95, para. 84) “. . . links cash flows that are often perceived to be related, such as cash proceeds from borrowing transactions and cash repayments of borrowings . . . [and results in a cash flow] . . . statement which reflects the cash flow impact of each of the major activities of the enterprise.”

There are several inconsistencies and ambiguities in this three-way classification, however, relating to the following: (1) arbitrariness of classifications; (2) interest earnings and interest cost; (3) retirement of bonded debt; and (4) income taxes.

Arbitrariness of Classifications

Most classification systems are somewhat arbitrary. Classification involves weighing the relative significance of similarities and differences. Under SFAS-95, the unavoidable arbitrariness of the three-way classification sometimes results in classifying similar cash flows differently and different cash flows similarly. Additionally, although the three-way classification of cash flows under SFAS-95 links certain related cash flows, it does *not* link other cash flows that are either functionally or legally related.

Operating versus investing activities—In a research monograph which influenced the FASB deliberations on cash flow reporting, Heath notes (1978, 129) that the purchase and sale of inventories is in one sense fundamentally the same as the purchase and sale of plant assets; both are usually considered part of a firm's normal *operating* activities. The case for treating the purchase and sale of plant assets differently from the purchase and sale of inventories must be based, Heath argues (*ibid.*, 130), on the grounds that they are of different significance to those interested in the cash inflows and cash outflows of a business enterprise. According to Heath (*ibid.*), the purchase and sale of plant assets are of special significance because they are of relatively infrequent occurrence, because they are often relatively large in amount, and be-

¹Classification depends on the nature of the firm's operations. It is presumed that investing activities include lending activities as well as acquisition and sale of securities, but that presumption may be overcome. For example, acquisitions and dispositions of securities held in trading accounts of broker dealers and loans originally acquired for resale by certain financial institutions are comparable to acquisition and disposition of inventories by merchandising and manufacturing companies, hence are classified (SFAS-102 1989, paras. 8-9) as operating activities, not investing activities.

cause management is likely to have more control over their timing than it does over the purchase and sale of inventories. Nonetheless, Heath notes (*ibid.*) that distinguishing between operating and investing activities is likely to be troublesome.

In its 1980 Discussion Memorandum, the FASB also recognizes (1980, 43) the similarity of purchases of inventory and purchases of plant assets. Unlike Heath, however, the FASB notes (*ibid.*) that one might argue that both represent *investing* activities. Nevertheless, the FASB (*ibid.*, 44) classifies the former as operating activities and the latter as investing activities, largely because “. . . payments to suppliers for inventories are regarded normally as part of operating activities and payments for property, plant, and equipment as part of investing activities.”

Thus, to the extent that payments for inventories and plant assets are fundamentally alike, the distinction between operating and investing activities is flawed or unnecessary. This notwithstanding, a consensus has developed that payments for inventories should be classified as operating outflows whereas payments for plant assets should be classified as investing outflows, consistent with the finance literature.

Operating versus financing activities—A similar ambiguity arises in classifying payments of amounts borrowed. Cash outflows to suppliers and lenders are fundamentally alike, yet the former are classified as operating whereas the latter are classified as financing under SFAS-95.

Heath notes (1978, 130-32) that some activities with a financing dimension, such as inventory purchases on account, should be excluded from financing activities because their spontaneous financing components are incidental to an enterprise's operations and do not affect its capital structure. According to Heath, only negotiated financing activities should be reported as financing activities. In its 1980 Discussion Memorandum, the FASB also notes (*ibid.*, 43) this ambiguity in the three-way classification. Nevertheless, both Heath and the FASB favor classifying cash outflows

to suppliers as operating and cash outflows to lenders as financing.

There are at least two inconsistencies in the reasoning underlying this classification. First, it assumes that inventory purchases on account always involve current liabilities. Second, it assumes that report users are interested principally in the capital structure which, by definition, excludes current liabilities. What about those admittedly less common situations where inventory purchases on account involve long-term liabilities? What about those report users interested in the financial structure which, by definition, includes all liabilities, not just long-term liabilities?²

Because cash outflows to suppliers and lenders are fundamentally alike, the distinction between operating and financing activities based on payee is ambiguous. This ambiguity has been resolved by classifying outflows to suppliers as operating and outflows to lenders as financing, consistent with the finance literature.

Investing versus financing activities—Finally, a similar ambiguity arises in distinguishing between investing and financing activities. SFAS-95 classifies cash flows according to the transactions that cause them. Cash inflows are not classified according to uses and, similarly, cash outflows are not classified according to sources.³ To illustrate this ambiguity, cash receipts from the sale of plant assets are investing inflows even when the proceeds are used to retire debt, and cash receipts from issuing debt are financing inflows even when the proceeds are used to purchase plant assets. Such cash inflows and outflows

²Some authors distinguish between financial structure and capital structure. For example, Weston and Copeland note (1992, p. 565) that financial structure refers to a firm's total financing, and includes current liabilities, deferred tax liabilities, long-term debt, preferred stock, and common stock (including retained earnings), whereas capital structure refers to its permanent financing, and includes just the latter three items.

³An exception is that cash flows from futures contracts, forward contracts, option contracts, or swap contracts accounted for as hedges of identifiable transactions or events may be classified in the same category as the items being hedged. See SFAS-104, para. 7(b).

might be viewed as functionally related, but are not necessarily "linked" and are not reported in the same section of the cash flow statement under SFAS-95.

Interest Collections and Interest Payments

For merchandising and manufacturing firms, most commentators (see, e.g., Smith and Skousen 1981, 107-108; Welsch et al. 1982, 87-88) suggest that interest earnings and interest cost relate to peripheral or incidental operating activities or to investing and financing activities, not to central operating activities, at least for income reporting purposes. The FASB appears to concur with this classification (FASB 1979a), for income reporting at the aggregate firm level.

For cash flow reporting, however, the FASB states that interest and dividend collections are operating inflows and interest payments are operating outflows unless capitalized (see SFAS-95, paras. 17, 22-23). This prescribed classification contradicts the finance literature. Clearly, interest and dividend collections result from making loans or investments in debt and equity securities and, therefore, relate to investment activities. Similarly, interest payments result from incurring debt and, therefore, relate to financing activities. Indeed, the finance literature emphasizes the similarity of interest and dividend payments—interest is paid for the use of debt capital, whereas dividends are paid for the use of equity capital. It follows, therefore, that interest and dividend receipts are *not* operating inflows and interest payments are *not* operating outflows, notwithstanding SFAS-95.

The FASB acknowledges (ibid., paras. 86, 89) that a reasonable case could be made for classifying interest payments as financing outflows and interest and dividend collections as investing inflows. But the FASB notes (ibid., para. 90) that under prior practice, almost all published funds statements implicitly classified interest collections and interest payments as operating flows. Additionally, it perceives widespread support (ibid.) for what might be referred to as the *inclusion concept*, whereby ". . . operating cash flow should, insofar as

possible, include items whose effects are included in determining net income to facilitate an understanding of the reasons for the differences between net income and net cash flow from operating activities." Because of this inclusion concept, the FASB concludes (ibid.) that it ". . . was not convinced that changing the prevalent [prior] practice . . . would necessarily result in a more meaningful presentation of cash flows." Rather, the FASB favors evolutionary changes in cash flow reporting (see ibid., para. 120) and, for the present, classifies interest payments and interest and dividend collections as operating cash flows.⁴

It is inconsistent, however, for the FASB to cite the inclusion concept and prior practice to decide that cash flow from operating activities should include interest payments and interest and dividend collections but exclude cash flows relating to gains and losses from plant asset disposals. Like interest payments and interest and dividend collections, gains and losses on plant asset disposals are included in net income, and the cash flows relating to these gains and losses were frequently included in operating funds flow under prior practice.⁵ Consistent citation of the inclusion concept and prior practice might have led the FASB to classify all of these cash flows as operating, a ridiculous result. Instead,

⁴Interestingly, the Governmental Accounting Standards Board (GASB) classifies interest and dividends receipts on loans (except program loans), debt instruments of other entities, equity securities, and cash management and investment pools as investing inflows, interest payments for purposes unrelated to capital assets as noncapital financing outflows, and interest payments directly related to capital assets as capital and related financing outflows; all other interest receipts and interest payments are classified as operating cash flows.

On the other hand, the International Accounting Standards Committee (IASC) proposes (1991, paras. 34-35) to classify interest and dividend receipts as either operating or investing inflows and interest payments as either operating or financing outflows.

⁵Under prior practice, most companies used the indirect method to calculate funds flow from operations, and income was not adjusted for nonoperating gains and losses. Accordingly, disposals of plant and equipment were reported at net book value, and nonoperating gains and losses were implicitly included in operating funds flow. See Nurnberg 1983, 810.

the FASB should have ignored the inclusion concept and prior practice and classified interest and dividend collections as investing inflows and interest payments as financing outflows, because they relate to investing and financing activities, as noted earlier.

More important, because interest and dividend collections and interest payments are classified as operating cash flows under SFAS-95, reported cash flow from operating activities includes cash flows relating to investing and financing activities. Similarly, reported cash flows from investing and financing activities exclude cash flows relating to these activities. It follows that the effectiveness of the cash flow statement to distinguish among operating, investing, and financing activities is impaired. Indeed, three of the seven FASB members dissented to the issuance of SFAS-95 in part for this reason.⁶

This impairment may be material. An extreme example of the impact of interest *payments* on cash flow from operating activities is found in the 1991 cash flow statement of Westinghouse. For 1991, consolidated operating cash flow is \$703,000,000 net of \$1,006,000,000 of interest payments. If these interest payments had been classified as financing outflows, consolidated operating cash flow would have increased by 243 percent to \$1,709,000,000.⁷ An extreme example of the impact of interest *collections* on operating cash flow is illustrated in the 1991 cash flow statement of the Financial Accounting Foundation. For 1991, operating cash flow is a positive \$655,000, including \$876,000 of interest collections, or 134 percent of the net amount. If these interest collections had been classified as investing inflows, operating cash flow would have been a negative \$221,000.

By classifying interest and dividend collections and interest payments as operating cash flows, the FASB has foregone the opportunity to more substantially improve the quality of financial reporting by sharpening the distinction among operating, investing, and financing cash flows.⁸ It should reconsider the issue.

Bonded Debt

SFAS-95 states that "repayments of amounts borrowed" are financing outflows (para. 20(b)), whereas "payments to lenders and other creditors for interest" are operating outflows (para. 23(d)). Unofficially, the FASB staff indicates that the intent of SFAS-95 is to classify repayments of *original* amounts borrowed as financing outflows. It follows that SFAS-95 requires the debtor to report an excess of maturity value over issuance price, or issuance discount, as an operating outflow, because it represents the additional interest cost paid in one lump sum (see also Stewart et al., 7). For zero coupon debt, all the interest cost is paid at maturity, and frequently exceeds the original amount borrowed.

⁶The FASB wavered in its deliberations with respect to classifying these items in the cash flow statement. Interest and dividend collections and interest payments were classified as operating in the July 1986 Exposure Draft. In March 1987, however, the FASB tentatively concluded to classify interest and dividend receipts as investing inflows and interest payments as financing outflows (see Action Alert, No. 87-11, 18 March 1987). But in April 1987, the FASB reverted to the original operating classification of the Exposure Draft (see Action Alert, No. 87-16, 22 April 1987).

⁷This and several additional examples from published financial reports illustrate the effect on cash flow from operating activities of including interest payments and collections, dividend collections, and the income tax effects of gains and losses relating to investing and financing activities. Of course, cash flow from operating activities should be adjusted to exclude all of these items, not just one item at a time as is illustrated in this paper. Space limitations preclude this more complete analysis.

⁸Mitigating this contaminating effect is the requirement of SFAS-95 to disclose the amount of interest payments (net of amounts capitalized), either as a separate line item under the direct method, or as a supplemental disclosure under the indirect method. The FASB reasons (SFAS-95, para. 90) that this disclosure will enable report users who wish to consider interest payments as financing outflows to do so for their own analytical purposes. Unfortunately, SFAS-95 has no comparable requirement to disclose the amount of interest collections as a supplemental item under the indirect method for report users who wish to consider interest collections as investing inflows for their own analytical purposes; it does require disclosure of interest and dividend collections as a separate line item under the direct method.

This treatment produces a peculiar if not counterintuitive presentation: Operating cash flow decreases due to the retirement of debt when the debt was issued at a discount, although the debt retirement itself is a financing activity (see Nurnberg 1990, 50-54).⁹ The dollar amounts may be material. For example, in its 1990 annual report, Turner Broadcasting System discloses (fn. 4) the repayment in 1989 of \$292,000,000 of accreted value of zero coupon senior notes. In its three-year comparative cash flow statement, Turner correctly deducts \$206,102,000 of payments of accreted amounts and discount expensed upon retirement of related securities¹⁰ from the subtotal \$410,286,000 operating cash flow *before* interest payments to calculate the \$25,792,000 operating cash flow for 1989. Operating cash flow would have been \$231,900,000, or 899.1 percent more than the \$25,792,000 reported amount, if this \$206,102,000 payment was reported as a financing outflow.¹¹

The peculiar presentation of cash outflows to retire debt originally issued at a discount results under SFAS-95 because of the classification of interest payments as operating outflows and debt repayments as financing outflows. A much more understandable and objective presentation classifies all payments to creditors as financing outflows, whether for interest or principal, consistent with the finance literature. This presentation also avoids the need to allocate payments to creditors between operating and financing activities.

Income Taxes

Because income tax payments and refunds are operating cash flows under SFAS-95, cash flow from operating activities includes the income tax effects of gains and losses relating to investing or financing activities, such as gains and losses on plant asset disposals and similar items.¹²

Similarly, under SFAS-95, cash flow from operating activities includes the income tax effects of certain noncash investing or financing activities. For example, exchanges of personality for realty are nonmonetary transactions involving dissimilar assets under APB

Opinion No. 29 (1973, paras. 18-21) and taxable exchanges under federal tax law. For both book and tax purposes, gain or loss is recognized for the difference between the fair value of the consideration received and the basis of the consideration given. Book gain or loss differs from tax gain or loss by any difference between book and tax basis.

Under prior practice, there were three acceptable methods of reporting the tax effects of gains and losses on plant asset disposals in the funds statement (see Nurnberg 1983, 808-811). Most firms did not allocate income taxes in the funds statement and reported as proceeds from plant asset disposals the book value, not the cash receipt. Under this *book*

⁹An analogously peculiar presentation in the cash flow statement of the bondholder results from applying SFAS-95 rules to the maturation of bond investments acquired at a discount: Operating cash flow increases by the accumulated discount, which represents interest collections, although the collection at maturity itself is an investing activity.

¹⁰It is not possible from the published disclosures to determine the portion of this \$206,102,000 payment that represents accreted interest on the zero coupon notes and the portion that represents discount expensed upon the retirement of related securities.

¹¹An alternative practice has developed of reporting the entire payment of debt at retirement as a financing outflow. This practice is illogical and contrary to the spirit of SFAS-95, however, as it understates the operating outflow for accreted interest cost and overstates cash flow from operating activities. The amount of the understatement of the operating outflow for interest cost and the overstatement of cash flow from operating activities increases the larger the issuance discount and the longer the maturity term of the debt. For zero coupon debt, this practice results in reporting no operating outflow for interest cost. For example, in its 1991 comparative cash flow statement, Imcera Group reports a \$217,400,000 financing outflow for the partial redemption of zero coupon debt, including accreted interest, and \$165,100,000 of operating cash flow for 1991. Unfortunately, the precise amount of accreted interest is not determinable from the published disclosures.

¹²A comparable situation arises for the tax effects of investing or financing transactions that involve no gain or loss for book purposes but gain or loss for tax purposes due to a difference between book and tax basis. For example, the sale of plant assets at book value generates no gain or loss for book purposes but results in gain or loss for tax purposes equal to the difference between book and tax basis. Under SFAS-95, cash flow from operating activities includes the income tax effects of these gains or losses for tax purposes.

value method, funds flow from operations was overstated by the after-tax gain or understated by the after-tax loss, and neither the before- nor after-tax proceeds from the disposal were reported as a single figure anywhere in the funds statement. A few firms allocated income taxes in the funds statement and reported plant asset disposals on an *after-tax* basis. This *intra-period tax allocation* method resulted in reporting funds flow from operations uncontaminated by the tax effects of the gain or loss on the disposal. Finally, some firms did not allocate income taxes in the funds statement and reported the cash proceeds from plant asset disposals on a *before-tax* basis. Under this *flow-through* method, funds flow from operations was reduced by any tax paid on the gain and increased by any tax savings on the loss. Although not documented, presumably there was a comparable variation in reporting the tax effects of other gains and losses in published funds statements under prior practice.

Under SFAS-95, however, only the flow-through method is permitted in the cash flow statement. SFAS-95 is an improvement over prior practice because it prohibits the book value method for plant asset disposals. But SFAS-95 is not as great an improvement as possible because it also prohibits intra-period tax allocation in the cash flow statement. The FASB reasons (SFAS-95, para. 92) that tax allocation in the cash flow statement "... would be so complex and arbitrary that the benefits, if any, would not justify the costs involved." Many years ago, the same type of criticism was directed at intra-period tax allocation in the income statement (see SEC 1945, 142-55; Greer 1945, 98-99), but the procedure has long since become a generally accepted accounting principle (see Patten 1964, 876-79; APBO-11 1967, paras. 51-52; SFAS-96 1987c, paras. 137-41; SFAS-109 1992, paras. 35-38). Both the APB and the FASB concluded that intra-period tax allocation in the income statement is *not* so complex and arbitrary and that the benefits more than justify the costs.

Income taxes should be allocated in the cash flow statement in order to more accu-

rately distinguish among cash flows from operating, investing, and financing activities. Although intra-period tax allocation for cash flow reporting requires estimates of tax payments attributable to individual investing and financing activities, these estimates may be made using intra-period tax allocation methods already developed for income reporting. Moreover, although any estimate may be complex and/or arbitrary, some estimate is better than no estimate at all. Without intra-period tax allocation, cash flow from operations is understated by the tax on gains and overstated by the tax savings on losses relating to investing and financing activities. Perhaps the FASB will ultimately conclude that intra-period tax allocation in the cash flow statement is no more complex and arbitrary than its income statement counterpart, and that the benefits more than justify the costs.

Under the current rules of SFAS-95, when the amounts are material, it is recommended (see Ernst and Whinney 1988, 23) that firms disclose the income tax effects of gains and losses relating to investing and financing activities, to alert report users that the reported cash flow from operating activities is contaminated by the tax effects of these gains and losses. For example, Alexander & Baldwin Inc. discloses in its 1990 annual report that the \$97,368,000 operating cash flow for 1989 has been reduced by \$36,890,000 of income taxes paid on gains from disposals of property and investments, although the proceeds from those disposals were included in cash flows from investing activities. Cash flow from operating activities uncontaminated by the taxes paid on these investing transactions is \$134,258,000, or 37.89 percent more than the reported amount. Another example is American Bankers Insurance Group, Inc., which discloses in its 1990 annual report (fn. 5) that approximately \$2,000,000 of tax payments in 1988 on the gain on the sale of an affiliate are reported under operating activities, although the proceeds from the sale are reported under investing activities. Accordingly, the \$77,186,000 operating cash flow for 1988 is 2.5 percent less than the \$79,186,000 amount

that would have been reported if the \$2,000,000 of tax payments were reported as an investing outflow.

Still more interesting is that some firms allocate income taxes in cash flow statements despite the prohibition of SFAS-95, presumably because the amounts reported for cash flow from operating activities would otherwise be considered to be misleading. For example, the 1990 comparative cash flow statement of Mead Corporation reports \$42,600,000 of income taxes on gains from sales of businesses and properties added back to net income to calculate the \$497,300,000 operating cash flow for 1988, and a \$42,600,000 outflow immediately after the \$333,800,000 inflow from sales of businesses and properties among investing activities; without this addback, cash flow from operating activities for 1988 would have been reported as \$454,700,000, or 9 percent less than the reported amount. Two much more dramatic examples are Fairchild Corporation and Capital Southwest Corporation. The fiscal 1991 comparative cash flow statement of Fairchild Corporation reports a \$69,500,000 outflow for income taxes paid on assets sold as an investing outflow in fiscal 1990; consistent with SFAS-95, cash flow from operating activities for fiscal 1990 would have been a negative \$231,630,000 rather than the negative \$162,130,000 amount reported, or 42 percent more. Similarly, the 1991 comparative cash flow statement of Capital Southwest Corporation reports a \$3,981,812 outflow for income taxes paid on realized investment gains as an investing outflow for fiscal 1989; under SFAS-95, cash flow from operating activities for fiscal 1989 would have been a negative \$2,581,540, 284 percent less than the positive \$1,400,272 actually reported.

NONCASH TRANSACTIONS

In the Exposure Draft to SFAS-95 (1986, para. 4), the FASB proposed that the primary purpose of the cash flow statement is to provide information about the cash receipts and cash payments of a firm during a period, and that a secondary purpose is to provide information about the investing and financing ac-

tivities of the firm during the period. Consistent with these two purposes, the Exposure Draft required disclosure of noncash investing and financing transactions either in the cash flow statement or in a separate schedule. Examples of noncash investing and financing transactions include (1) converting debt to equity, (2) acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller, (3) obtaining an asset by entering into a capital lease, and (4) exchanging noncash assets or liabilities for other noncash assets or liabilities. Formerly, such transactions were reported as nonfund investing and financing activities in the statement of changes in financial position. By permitting disclosure of these noncash investing and financing transactions in the cash flow statement, the Exposure Draft held open the possibility that a comparative cash flow statement for a series of years, like the predecessor comparative statement of changes in financial position, would report all the investing and financing activities of a firm.

Unlike the Exposure Draft, however, SFAS-95 (para. 4) retains the primary purpose but deletes the secondary purpose of the cash flow statement. The FASB concluded that the effectiveness of the cash flow statement would be enhanced if its purpose was restricted to reporting only cash flows, and therefore prohibits reporting noncash transactions in the cash flow statement. Nevertheless, SFAS-95 requires (para. 32) disclosure of all noncash investing and financing transactions that affect recognized assets or liabilities but that do not result in cash inflows or outflows. The FASB reasons (SFAS-95, para. 70) that although these noncash transactions result in no cash inflows or outflows in the periods in which they occur, they generally have a significant effect on cash flows in subsequent periods. SFAS-95 makes more uniform the reporting of noncash investing and financing transactions by prescribing supplemental disclosure outside the cash flow statement and prohibiting their disclosure in the cash flow statement. Unfortunately, the result of this narrower focus is that a comparative cash flow statement, unlike a comparative statement of changes in

financial position, does not report all of a firm's investing and financing transactions.

For example, if a firm acquires equipment under capitalized leases, the inception of the lease is a noncash investing and financing transaction to be disclosed outside the cash flow statement, whereas the subsequent lease payments are allocated between interest and principal and reported in the cash flow statement as operating and financing outflows, respectively. Accordingly, a comparative cash flow statement for a series of years does not report all investing and financing transactions relating to this lease. Neither the original investment outflow nor the original borrowing inflow is reported in the cash flow statement, but the repayment is reported later as a financing outflow. From a cash flow statement perspective, the firm appears to be paying off a phantom loan, although the loan itself is reported in the balance sheet. A similar result occurs when a firm acquires real estate by assuming an existing mortgage or by giving a mortgage or installment note to the seller. Only the downpayment is reported as an investing outflow; all subsequent principal payments are reported as financing outflows.

Still another example of the incomplete reporting of financing activities in the cash flow statement under SFAS-95 is the conversion or exchange of debt for equity. A comparative cash flow statement reports the original borrowing as a financing inflow, but settlement of the debt by conversion or exchange is not reported as a financing outflow because it does not involve cash.

INSTALLMENT PURCHASES AND SALES OF PLANT ASSETS

Under SFAS-95, there are certain inconsistencies in reporting installment purchases and sales of plant assets. For installment *purchases* of plant assets, only *early* payments of principal, such as advance payments and down payments, are investing cash outflows (SFAS-95, para. 17(c), fn. 6); subsequent installment payments of principal are financing outflows.¹³ For installment *sales* of plant assets, however, *all* installment receipts of principal are investing inflows (SFAS-95, para.

16(c))—not just the early receipts of principal.¹⁴ The inconsistency results from classifying *all* installment receipts of principal on sales of plant assets as investing inflows but only *some* installment payments of principal on purchases of plant assets as investing outflows. Moreover, because most installment payments of principal on purchases of plant assets are classified as financing outflows, a comparative cash flow statement for a series of years does not report all the investing and financing activities of a firm.¹⁵

Additionally, SFAS-95 provides little guidance in defining advance payments and down payments. This is a particular concern for equipment acquired under capitalized leases. Conceptually, the early lease payments are analogous to down payments in purchase-borrow transactions, and should be classified as investing outflows. In Appendix A of SFAS-95, however, the illustrative lease transaction is treated in its entirety as a noncash investing and financing transaction, and none of the lease payments are classified as investing outflows. SFAS-95 implies, therefore, that all payments under a capital lease are for interest and principal on a loan and should be classified as operating and financing outflows, respectively, and that no payments are down

¹³The FASB concluded (1987, para. 96) that it would be unduly burdensome to separate installment payments to sellers of plant assets, which otherwise would be investing outflows, from installment payments to third-party creditors, which are financing outflows. Rather, SFAS-95 classifies both types of installment payments as financing outflows.

¹⁴SFAS-95 does not explicitly consider the ease or difficulty of separating receipts of principal from installment sales of plant assets from other installment receipts. Presumably, it concluded that it would *not* be unduly burdensome to separate installment receipts from buyers of plant assets, which are investing inflows, from installment receipts from creditors for serialized borrowings such as reverse equity realty loans, which are financing inflows.

¹⁵There is another inconsistency in the classification of payments of installment debt under SFAS-95 (paras. 17(c), fn. 6, and 95-96): As noted earlier, installment payments for plant asset purchases are financing outflows, not investing outflows, although they result from plant asset purchases, which are classified as investing activities. On the other hand, installment payments for inventories are operating outflows, even though they could be viewed as financing outflows.

payments classified as investing outflows. One author (see Mosich 1989, 1183) explicitly concurs with this view, even for leases in which the first annual payment occurs at the inception of the lease and clearly functions as a down payment.

UNCLEAR DISCLOSURE REQUIREMENTS

Although SFAS-95 requires supplemental disclosure of noncash investing and financing transactions, it is not clear which noncash transactions require disclosure and which do not. For the most part, the noncash investing and financing transactions for which separate disclosure is explicitly required by SFAS-95 involve external parties and were formerly reported in the statement of changes in financial position as separate nonfund resources provided and applied.

Under prior practice, each of these noncash transactions was typically viewed as equivalent to two hypothetical transactions, a cash inflow and a cash outflow of equal amount. For example, because acquisitions of equipment under capitalized leases were viewed as equivalent to a long-term borrowing followed by immediate payment to acquire equipment, such external noncash transactions were reported in the statement of changes in financial position. As noted earlier, they must also be disclosed under SFAS-95, but *not* in the cash flow statement.

Although the rationale of two hypothetical cash transactions is satisfactory for some purposes, it opens the way for other hypothetical interpretations which are not so acceptable. As Moonitz noted long ago (1956, 380), it is preferable to emphasize that funds flow as a result of external transactions, rather than postulate hypothetical cash transactions. Thus, stock dividends were not usually reported in the statement of changes in financial position, even though stock dividends could be viewed as equivalent to two hypothetical transactions—payment of a cash dividend followed immediately by issuance of stock to the same stockholders for cash. Besides, stock dividends were adequately re-

ported in the statement of changes in stockholders' equity. For similar reasons, stock dividends do not represent noncash financing transactions requiring disclosure under SFAS-95, presumably because they are not external transactions and also because they are adequately disclosed elsewhere in financial reports. Nevertheless, stock dividends are occasionally disclosed among noncash financing activities. As an example, Commerce Clearing House reports (1991, 17, 25) a \$17,418,000 common stock dividend among the supplementary disclosures of noncash financing activities as well as in the statement of changes in stockholders' equity.

Several authors (see, e.g., Mosich 1989, 1187; Seiler 1991, 8-22; Williams et al. 1989, 1185-86) conclude, however, that *cash* dividend declarations per se *are* noncash financing transactions requiring disclosure under SFAS-95 when the amounts declared differ from the amounts paid during the year. This issue is not addressed explicitly in SFAS-95. In practice, a few firms (see, e.g., Cash America Investments; Farmland Industries; Larrizza Industries) disclose dividend declarations with the disclosures of noncash investing and financing activities. Presumably, most firms conclude that any differences between dividends declared and dividends paid are adequately disclosed by comparing amounts reported in the cash flow and retained earnings statements.

Under prior practice, reclassifications of noncurrent liabilities as current liabilities often were reported as nonfund resources applied and provided in the funds statement because "... the pool of net disposable money-assets or of net working capital . . . [was] diminished . . . [by] an event giving rise to a decline in funds" (Moonitz 1956, 382). Although not explicitly considered in APBO-19, some authors (see, e.g., Kieso and Weygandt 1983, 1087; Miller et al. 1982, 767) interpreted that pronouncement to require disclosure of debt reclassifications as nonfund resources provided and applied, whereas other authors (see, e.g., Davidson et al. 1985; Danos and Imhoff 1986) did not address the issue.

SFAS-95 does not explicitly consider whether debt reclassifications should be disclosed as sig-

nificant noncash financing activities. Some authors (see, e.g., Mosich 1989, 1183) interpret SFAS-95 to require disclosure of debt reclassifications as noncash financing activities, whereas other authors (see, e.g., Chasteen et al. 1989; Kieso and Weygandt 1989; Nikolai and Bazley 1991; Seiler 1989; Smith and Skousen 1990; Welsch and Zlatkovich 1989; Williams et al. 1989) do not address the issue. In practice, few firms (see, e.g., DST Systems Inc.; Mechanical Technology Incorporated; Pacific Enterprises; Rent-A-Wreck of America, Inc.; and Simetco Inc.) disclose debt reclassifications along with disclosures of noncash investing and financing activities. Most such disclosures involve reclassifications from current to noncurrent, not noncurrent to current.

THIRD-PARTY FINANCING TRANSACTIONS

Although the cash flow statement reports only cash flows, SFAS-95 does not provide adequate guidance as to whether cash actually flows in some third-party financing transactions. Cash inflows occur as checks are received and deposited, and cash outflows occur as checks are issued, but some third-party financing transactions do not involve deposits and issuances of checks.

For example, assume a firm obtains third-party financing for equipment purchases. The third-party creditor issues a check payable to the firm, which the firm immediately endorses over to the equipment dealer rather than depositing it and issuing its own check. Does receipt of the third-party check constitute a cash inflow? Does endorsement of the check constitute a cash outflow? SFAS-95 does not provide definitive guidance. Some firms report such transactions gross, as both financing inflows and investing outflows, whereas other firms report such transactions net in the cash flow statement with supplemental disclosure among noncash financing and investing activities, but the variations cannot be documented from published cash flow statements. Does the reporting change if the check is payable to the equipment dealer but given to the firm which in turn gives it to the dealer? Does the report-

ing change if the third-party creditor mails the check directly to the equipment dealer? Again, SFAS-95 does not provide definitive guidance.¹⁶

Limited guidance is provided for third-party financing provided by banks. Here the FASB reasons (SFAS-95, para. 7, fn. 1) that because cash includes demand deposits, charges and credits to a demand deposit account are cash receipts and cash payments to both the firm owning the account and the bank holding it. Accordingly, for third-party financing provided by banks, the transaction is reported gross if the firm's demand deposit account is increased for the loan and decreased for the payment, regardless of whether the firm endorses or conveys a bank check to the equipment dealer. The transaction is reported net, however, if the firm's demand deposit account is *not* affected by the loan and subsequent payment. Thus, the cash flow statement presentation of the transaction by the borrower depends on the internal accounting for the transaction by the lender!¹⁷ This is contrary to the usual situation where the financial reporting of a transaction by one firm is unaffected by the financial reporting by the other party to the transaction.

SUMMARY AND CONCLUSIONS

This paper compared the distinctions in SFAS-95 among operating, investing, and financing activities with similar distinctions in the finance literature. It identified several in-

¹⁶These issues were considered by the FASB at a meeting on 26 October 1988. The FASB promised some additional guidance, but in the form of a journal article by a FASB staffperson rather than a question and answer implementation guide. Unfortunately, the staffperson left the FASB before completing the journal article.

¹⁷Similarly, when a firm rolls over a certificate of deposit upon maturity, the bank may or may not increase and decrease the firm's demand deposit account, yet the FASB reasons (SFAS-104, 1989, para. 20) that one procedure results in a cash inflow and a cash outflow, whereas the other results in neither. Thus, the firm whose bank increases and decreases its demand deposit account when a loan or certificate of deposit is renewed reports higher cash flows relative to another firm whose bank does not adjust its demand deposit account for such renewals.

consistencies and ambiguities in the three-way classification of cash flows under SFAS-95, and demonstrated how the effectiveness of the cash flow statement and related disclosures to distinguish among operating, financing, and investing activities is impaired.

More specifically, this paper demonstrated that the three-way classification under SFAS-95 and the ambiguous presentation of third-party financing transactions result in reporting similar cash flows differently and different cash flows similarly, just the opposite of the desired characteristic of financial reporting to report similar things similarly and different things differently. The paper also demonstrated that the classification of interest, income taxes, and dividend collections as operating cash flows results in contaminating cash flow from operating activities with the interest and dividend effects of investing and financing activities as well as with the tax effects of gains and losses relating to investing and financing activities, and produces a peculiar if not counterintuitive cash flow statement presentation of the retirement of bonded debt originally issued at a discount. Finally, this paper demonstrated that the require-

ments to report third-party financing transactions and disclose noncash investing and financing transactions are ambiguous.

Thus, this paper demonstrated that SFAS-95 is internally inconsistent and ambiguous in some important respects. Because the FASB has so far been unable to more substantially sharpen the distinction among operating, financing, and investing cash flows, it has foregone the opportunity to further enhance the comparability of cash flow statements.

By highlighting these inconsistencies and ambiguities, it is hoped that readers will be more aware of certain limitations of cash flow statements prepared under SFAS-95. More specifically, it is hoped that readers have been made aware that the amount reported as cash flow from operating activities does not reflect all of the cash flow consequences of operating activities and, similarly, that the amounts reported as cash flow from investing and financing activities do not reflect all of the cash flow consequences of investing and financing activities, respectively. Accordingly, these amounts should not be incorporated into operating, investing and financing decision models without adjustment.

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