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THE CASH FLOW CLASSIFICATION OF DISTRIBUTIONS RECEIVED FROM UNCONSOLIDATED ENTITIES

BY EUGENE E. COMISKEY AND CHARLES W. MULFORD

EXECUTIVE SUMMARY

In this research report we examine the cash flow classification of distributions received from equity-accounted investments and find some problematic classifications. Distributions exceeded by investee earnings are considered to be returns *on* investment, indicating an operating cash flow classification is appropriate. Distributions that are returns *of* investment, that is, paid out of capital, are properly classified as investing cash flow. Out of a sample of 107 firms, 70 classify all of the distributions received into operating cash flow. This is not surprising since these investor firms report equity earnings that appear to exceed the distributions received. However, 19 firms classify all distributions received into investing cash flow. For 13 of these firms, earnings exceeded all of the distributions received, suggesting that they too were being paid a return on investment. As a result, the distributions received arguably should be included in operating cash flow. A revision of the operating cash flow of these 13 firms increases their operating cash flow by as much as 107%, with mean and median increases of 16% and 5%, respectively. Direct clarification obtained from some of the sample firms sheds light on the decisions made. However, even with clarification, an operating cash flow classification appears to be more appropriate.

Given the importance of operating cash flow to a firm's performance, the report's findings have implications for analysts and investors who will want to make sure that distributions received are properly classified. Managements and auditors will want to review cash flow classifications for distributions received from equity-accounted investments to ensure accurate reporting.

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Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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The Cash Flow Classification of Distributions Received from Unconsolidated Entities by Eugene E. Comiskey and Charles W. Mulford

Refer to Exhibit 1, pages 5 - 7 for companies included in this research report.

Introduction

The equity method of accounting is used for investments where an investor company has "significant influence" over the operating and financial policies of the investee. A presumption of significant influence exists when voting ownership is 20% or more (though an investee is typically consolidated when ownership extends beyond 50%, giving the investor control). However, even if ownership is less than 20%, the equity method may still be appropriate as long as the presence of significant influence can be established. For example, one way to establish significant influence is through board representation.[1]

Under the equity method, an investment is initially recorded at cost. Subsequent to purchase, the investment is increased by the investor's recognition of its share of the investee's earnings or decreased by its share of any losses. Additional investments made by the investor serve to increase the investment balance. Dividends and other distributions received by the investor from the investee are accounted for as a reduction in the carrying value of the investment.

In this research report, we focus on the cash flow classification of dividends and other distributions received by investors from equity-accounted investments.[2] While there is agreement that such cash receipts serve to reduce the investment balance, there is diversity in practice in the classification of those receipts on the statement of cash flows. In similar circumstances, some investors classify cash distributions received into operating cash flow while others report them as investing cash flow.

For example, Air Products and Chemicals reports substantial equity earnings in each year from 2003 to 2005, and all distributions received from its equity-accounted investments are included in operating cash flow. Alternatively, Armstrong Holdings, which also reports substantial equity earnings in 2003 to 2005, disclosed distributions received as investing cash flow only.

Accounting guidance on the classification of cash distributions received from equity-accounted investments is found in SFAS No. 95, *Statement of Cash Flows*. This Standard calls for distributions that represent returns *on* investment to be reported as operating cash flow and for distributions representing returns *of* investment an investing classification is appropriate.[3] This dichotomy between returns *of* and returns *on* investment seems relatively clear in concept.

[1] Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* (NY: Accounting Principles Board, 1971) and FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock,* (Norwalk, CT: Financial Accounting Standards Board, 1981).

[2] A similar study by Eugene Comiskey focused on Real Estate Investment Trusts (REITs). See "The Classification by Real Estate Investment Trusts of Distributions from Unconsolidated Entities." *Accounting Horizons,* June 2006, pp. 111-132.

[3] SFAS No. 95, *Statement of Cash Flows,* (Norwalk, CT: Financial Accounting Standards Board, 1987), paras. 15(b) and 22(b).

However, our review of company annual reports and interactions with company financial officers suggest that this classification scheme is at times a challenge to implement.

For example, in the case of Armstrong Holdings above, the company reports substantial earnings from its equity-accounted investments between 2003 and 2005. As such, it would appear that distributions received by them from those investments were returns *on* investment, which would call for their classification as operating cash flow, rather than returns *of* investment, which would call for an investing classification.

A key objective of the Financial Accounting Standards Board (FASB) is to reduce diversity in financial accounting and reporting practice, especially when such diversity is not associated with differences in surrounding facts and circumstances. Diversity in the classification of distributions received from equity-accounted investments has the potential to reduce the inter-firm comparability of the key cash-flow classifications, e.g., operating, investing and financing activities. Key cash flow measures, such as free cash flow, are affected by these classification decisions. Improper classifications of these distributions may mislead users who in recent years have increasingly focused on the use of cash-flow information. This reliance is often based upon a belief that various cash-flow measures are both more relevant and less susceptible to manipulation than earnings.

The Study

We developed a sample of 107 firms that reported use of the equity method for investments and received distributions from those investments during the years 2003 through 2005. The sample concentrates on commercial, industrial and retail companies, and excludes financial firms.

The information recorded for the sample of investor firms includes their classification of distributions received from investees into operating cash flow, investing cash flow, or both. In addition, the amounts of equity earnings or losses recognized and distributions received are recorded for the period of 2003 to 2005. Moreover, all financial statement balances related to the equity-accounted investments are examined along with relevant footnote disclosures. Commentary in managements' discussion and analysis of financial conditions and results of operations (MD&A) is also reviewed, with special attention given to the discussion of liquidity and cash flows.

In addition to the above information, an effort is made to get direct input about classification decisions from the sample firms. We sent individualized letters to the chief financial officer of 47 (44%) of the 107 sample companies. This subset of firms consists of companies whose classifications are judged to be especially relevant to the thrust of the study. Letters were sent to 11 firms that classify all distributions received as operating cash flow, 20 firms that classify all distributions received as investing cash flow, and 16 firms that classify distributions received into both operating and investing cash flow. The letters do not challenge the classification decisions of any of the sample firms and we believe that the questions posed should not be seen as violating any disclosure restrictions or regulations, e.g., Regulation FD.

Overall Classification Results

The classifications by the 107 sample firms of the distributions received from equity-accounted investments are presented in Exhibit 1. These classifications are based on the reporting period of 2003 through 2005. Of the 107 sample firms, 70 firms (65%) classify distributions into operating activities only and 19 firms (18%) firms classify distributions into investing activities only. The remaining 18 firms (17%) divide distributions received between operating and investing activities. These latter firms would appear to have received distributions that include both returns *on* and returns *of* investment.

The high percentage of classifications into operating cash flow is not surprising since most of these firms recognize equity earnings that exceed the distributions received during the study period of 2003 to 2005. An operating classification is based upon the distributions being returns *on* and not returns *of* investment. The presence of equity earnings that equal or exceed the distributions received support the propriety of an operating cash flow classification. However, an operating cash flow classification also could be appropriate in the absence of current-year equity earnings if the investor firm has sufficient undistributed equity earnings from previous years.

Some of the collected statistical data support the classifications of the operating cash flow-only firms. For these firms, the ratio of equity earnings recognized to distributions received over the period of 2003 through 2005 has a mean of $2.3 in equity earnings to $1 in distributions and a median of $1.4 in equity earnings to $1 in distributions. When there is on average $2.30 in equity earnings backing each dollar of distributions received, those distributions appear to be returns on investment and properly classified as operating cash flow. Seventy five percent of the operating cash flow-only firms had a ratio of equity earnings to distributions received of $1 or more in equity earnings to $1 in distributions, with the ratios ranging from a low of $0.3 to $1 to a high of $37.0 to $1.

The distributions received by the operating cash flow-only firms averaged 12.0 percent of total operating cash flow for the three-year period of 2003 through 2005. The median was 5.0 percent and the range was from 0.1 to 147.0 percent. While there is considerable range in the magnitude of distributions received, on average the distributions classified into operating cash flow should be considered to be material in amount.

While the operating cash flow-only firms and those that classify distributions into both operating cash flow and investing cash flow are of interest, firms that classify distributions only into investing cash flow, referred to here as investing cash flow-only firms, represent possible problematic classifications. A closer look at them follows.

Exhibit 1: Cash Flow Classification of Distributions Received from Unconsolidated Entities

Company	Cash Distributions Operating	Investing	Both
Abbott Laboratories	X		
Accuride Corp.	X		
AES Corp.	X		
Air Products & Chemicals, Inc.	X		
Alcan, Inc.	X		
Alliant Energy Corp.	X		
Alltel Corp.		X	
Amerada Hess Corp.	X		
American Standards Cos. Inc.	X		
American Vantage Cos.		X	
Ameron International Corp.	X		
Anheuser-Busch Cos. Inc.	X		
ANR Pipeline Co.	X		
Arch Chemicals, Inc.	X		
Archer Daniels Midland, Inc.			X
Armstrong Holdings, Inc.		X	
AT&T, Inc.	X		
Beazer Homes USA, Inc.			X
BorgWarner, Inc.	X		
Bristol-Myers Squibb Co.	X		
Cagles, Inc.	X		
California Steel Industries, Inc.		X	
Carey, W.P., LLC			X
Casella Waste Systems, Inc.	X		
Celanese Corp.	X		
Centennial Communications Corp.	X		
Centex Corp.			X
Church & Dwight Co.			X
CMS Energy Corp.	X		
Coca-Cola Co.	X		
Comstock Homebuilding Cos., Inc.			X
Covanta Energy Corp.	X		
Deere & Co.	X		
Devcon International Corp.	X		
Dow Chemical Co.			X
Eagle Materials, Inc.	X		
Eastman Kodak Co.			X
Entergy Corp.			X
Exxon Mobile Corp.	X		
EZCORP, Inc.		X	
First Hartford Corp.	X		
Ford Motor Co.	X		
General Mills, Inc.		X	

Exhibit 1 (continued)

Company	Operating	Investing	Both
Genesee & Wyoming, Inc.		X	
Gerdau Ameristeel Corp.	X		
Grant Prideco, Inc.	X		
GTECH Holdings Corp.	X		
Hanover Compressor Co.			X
HealthSouth Corp.	X		
Hector Communications Corp.	X		
Hilton Hotels Corp.	X		
HollyCorp.	X		
Honeywell International, Inc.	X		
Jones Lang Lasalle, Inc.			X
Kaiser Aluminum Corp.	X		
Kaiser Ventures, LLC		X	
Kansas City Southern	X		
Keyspan Corp.	X		
Land O'Lakes, Inc.		X	
Layne Christensen Co.	X		
Leucadia National Corp.			X
Levitt Corp.		X	
Libbey, Inc.		X	
Loews Corp.	X		
McDermott International, Inc.	X		
Merck & Co., Inc.	X		
Millennium Chemicals, Inc.			X
Modine Manufacturing Co.	X		
Mylan laboratories, Inc.	X		
National Fuel Gas Co.	X		
NL Industries, Inc.	X		
National Wine & Spirits, Inc.	X		
Newmont Mining Corp.	X		
New ULM Telecom, Inc.	X		
Noble Corp.	X		
Olin Corp.		X	
Owens-Illinois, Inc.	X		
Palm Harbor Homes, Inc.		X	
Peabody Energy Corp.	X		
PepsiCo, Inc.	X		
Phelps Dodge Corp.	X		
Poly One Corp.			X
PPG Industries, Inc.	X		
Quaker Chemical Corp.			X
Quicksilver Resources, Inc.		X	
Reading International, Inc.	X		
Reserve Petroleum Co.		X	
Ruby Tuesday, Inc.		X	
Schlumberger Ltd.	X		
Schnitzer Steel Industries, Inc.[a]		X	
Southern Natural Gas Co.	X		

Exhibit 1 (continued)

Company	Operating	Investing	Both	
Texas Roadhouse, Inc.	X			
The Andersons, Inc.	X			
Thomas Industries, Inc.	X			
Tidewater, Inc.	X			
Toll Brothers, Inc.			X	
Union Carbide Corp.			X	
United Refining Co.		X		
United States Steel Corp.	X			
Universal Security Instruments, Inc.		X		
Valero Energy Corporation			X	
Viacom, Inc.	X			
Walt Disney Co.	X			
Westmoreland Coal Co.	X			
West Pharmaceutical Services, Inc.	X			
Wheeling-Pittsburgh Corp.	X			
Worthington Industries, Inc.	X			
Totals	70	19	18	107

[a]On July 18, 2006, Schnitzer Steel announced that it would file an amended Form 10-K in order to "…reclassify cash received from joint ventures from the 'net cash provided by investments' section of the statement [of cash flows] to 'net cash provided by operations.'"

Reconsidering Investing-Related Distributions as Operating Cash Flow

The apparent, most problematic classifications are those of firms that, even with substantial equity earnings during the 2003 to 2005 time period, classify all distributions received as investing cash flow. On the surface, it would appear that these firms should classify distributions as operating cash flow, as they appear to represent returns on investment. Consider the findings reported in Exhibit 2.

Exhibit 2 summarizes information that indicates the presence of sufficient equity earnings for most of the investing cash flow-only firms to classify some or all of their distributions as operating cash flow. This statement must be tempered somewhat because it is possible that some of these equity earnings were derived from investing transactions, e.g., profits on the sale of investments or fixed assets. To the extent that this were the case, then the classification into investing cash flow of some or all of the distributions would be appropriate. However, no evidence of such return of investment actions was uncovered in our examination of each firm's financial statements and footnotes. Further, written clarification for a number of the investing cash flow-only firms reveals that the lack of investment profits is not the basis for their cash flow classifications.

Of the 19 investing cash flow reporting firms, 13 recognized equity earnings between 2003 and 2005 that exceeded all of the distributions received during that time period. Even in the absence of current equity earnings, some of the investing cash flow-only firms may have undistributed earnings from earlier years that could provide the basis for classifying part or all of the distributions received into operating cash flow. For example, in addition to recognizing very substantial equity earnings between 2003 and 2005, Genesee & Wyoming (firm 7 in Exhibit 2), also disclosed $58 million of undistributed equity earnings at December 31, 2005. Moreover, American Vantage, Levitt Corp., Palm Harbor Homes and Reserve Petroleum Co. (firms 2, 10, 13 and 15, respectively) recognized sufficient equity earnings to classify half or more of their distributions into operating cash flow. The remaining two firms, California Steel Industries, Inc. and Libbey, Inc. (firms 4 and 11, respectively) had a recent history of recording losses on their equity-accounted investments and an investing cash flow classification in their cases seems appropriate.

Exhibit 2: Full Earnings Coverage of Distributions Classified into Investing Cash Flow

Company	Yes	No
1. Alltel Corp.	X	
2. American Vantage Companies		X
3. Armstrong Holdings, Inc.	X	
4. California Steel Industries, Inc.		X
5. EZCORP, Inc.	X	
6. General Mills, Inc.	X	
7. Genesee & Wyoming, Inc.	X	
8. Kaiser Ventures LLC	X	
9. Land O' Lakes, Inc.	X	
10. Levitt Corp.		X
11. Libbey, Inc.		X
12. Olin Corp.	X	
13. Palm Harbor Homes, Inc.		X
14. Quicksilver Resources, Inc.	X	
15. Reserve Petroleum Co.		X
16. Ruby Tuesday, Inc.	X	
17. Schnitzer Steel Industries, Inc.	X	
18. United Refining Co.	X	
19. Universal Security Instruments, Inc.	X	

In addition to the presence of substantial equity earnings, the use of the label *dividends* by a number of investing cash flow-only firms suggests distributions that one would expect to see classified as operating cash flow. SFAS No. 95 includes dividends among the items identified as properly classified as operating cash flow: "Cash receipts from returns *on* loans, other debt instruments or other entities, and equity securities—interest and *dividends.*"[4] Refer to Exhibit 3 where we summarize the descriptors used for distributions received by investing cash flow-only firms.

In reviewing Exhibit 3, note that Alltel Corp. (firm 1) labels the distributions it received as a return *on* investments. Unless this is simply a mistake and they intended to refer to a return *of*

[4]SFAS No. 95, *Statement of Cash Flows,* (Norwalk, CT: Financial Accounting Standards Board, 1987), para. 22 (b).

investment, their classification is in conflict with SFAS No. 95. Quicksilver Resources (firm 14) identifies its distributions as a "Return *of* investment from equity affiliates" and Levitt (firm 10) labels its distributions as "distributions of capital." For each of these firms, the classification of distributions as investing cash flow appears to be appropriate as long as the distributions are in fact returns *of* capital. Five of the firms in Exhibit 3 (numbers 4, 5, 9, 11 and 18) label the distributions received as dividends, which suggests a return on investment. The balance of the firms use labels such as simply "distributions received" or "cash received," which do not convey any information about the character of the distributions.

Exhibit 3: Descriptors of Distributions Classified in Investing Cash Flow

Company	Descriptor
1. Alltel Corp.	Proceeds from the return on investments
2. American Vantage Companies	Cash distribution from unconsolidated subsidiary
3. Armstrong Holdings, Inc.	Distributions from equity affiliates
4. California Steel Industries, Inc.	Dividends received from affiliate
5. EZCORP, Inc.	Dividends from unconsolidated affiliates
6. General Mills, Inc.	Investments in businesses, intangibles and affiliates, net of investment returns and dividends
7. Genesee & Wyoming, Inc.	Cash from unconsolidated international affiliates
8. Kaiser Ventures, LLC	Distribution from West Valley MRF
9. Land O'Lakes, Inc.	Dividends from investments in affiliated companies
10. Levitt Corp.	Distributions of capital from real estate JVs
11. Libbey, Inc.	Dividends received from equity investments
12. Olin Corp.	Distributions from affiliated companies, net
13. Palm Harbor Homes, Inc.	Distributions from investment in limited partnership
14. Quicksilver Resources, Inc.	Return of investment from equity affiliates
15. Reserve Petroleum Co.	Cash distributions from equity investments
16. Ruby Tuesday, Inc.	Distributions received from unconsolidated franchises
17. Schnitzer Steel Industries, Inc.	Cash received from joint ventures
18. United Refining Co.	Dividends received
19. Universal Security Instruments, Inc.	Cash distributions from joint venture

Impact of Reclassifying Distributions to Operating Cash Flow

The information provided in Exhibits 2 and 3 suggest that at least some of the investing cash flow-only firms may be understating operating cash flow by reporting all of the distributions received from unconsolidated entities as investing cash flow. Exhibit 4 shows revised measures of operating cash flow that are developed by adding distributions classified as investing cash flow to reported operating cash flow. However, note that Exhibit 4 limits the cash flow revisions to the 13 firms in Exhibit 2 that reported sufficient earnings coverage of distributions received, satisfying the requirement that distributions reported as operating cash flow must be returns on investment.

In examining Exhibit 4, it is noted that the mean percentage increase in operating cash flow across the period 2003 through 2005 from the reclassification of distributions from investing cash flow to operating cash flow is 15.8% with a median of 4.5%. Operating cash flow at several firms was affected by significant amounts, some over 100%. In one case, Kaiser Ventures, a reported use of cash from operations in 2004 was converted to an adjusted source of cash. In general, these percentages indicate that the failure to classify some distributions into operating cash flow may materially reduce operating cash flow.

Exhibit 4: Revised Operating Cash Flow

(thousands of dollars)	2003	2004	2005
Alltel:			
Reported operating cash flow	$2,475,000	$2,467,000	$2,697,000
Adjustment	48,300	88,600	36,900
Revised operating cash flow	$2,523,300	$2,555,600	$2,733,900
Percent Revision	2.0%	3.6%	1.4%
Armstrong Holdings, Inc.:			
Reported operating cash flow	$ 165,800	$ 142,800	$ 146,700
Adjustment	16,000	10,000	23,000
Revised operating cash flow	$ 181,800	$ 152,800	$ 169,700
Percent Revision	9.7%	7.0%	15.7%
EXCORP, Inc.:			
Reported operating cash flow	$ 15,341	$ 27,225	$ 31,724
Adjustment	523	680	861
Revised operating cash flow	$ 15,864	$ 27,905	$ 32,585
Percent Revision	3.4%	2.5%	2.7%
General Mills, Inc.:			
Reported operating cash flow	$1,631,000	$1,461,000	$1,711,000
Adjustment	95,000	60,000	83,000
Revised operating cash flow	$1,726,000	$1,521,000	$1,794,000
Percent Revision	5.8%	4.1%	4.9%
Genesee & Wyoming Inc.:			
Reported operating cash flow	$ 47,284	$ 55,446	$ 68,097
Adjustment	132	5,757	677
Revised operating cash flow	$ 47,416	$ 61,203	$ 68,774
Percent Revision	.3%	10.4%	1.0%
Kaiser Ventures LLC:			
Reported operating cash flow	$ (9,142)	$ (2,105)	$ (3,154)
Adjustment	2,250	2,250	1,750
Revised operating cash flow	$ (6,892)	$ 145	$ (1,404)
Percent Revision	24.6%	106.9%	55.5%

Exhibit 4 (continued)

(thousands of dollars)	2003	2004	2005
Land O'Lakes, Inc.:			
Reported operating cash flow	$ 230,490	$ 202,024	$223,082
Adjustment	37,356	47,846	35,250
Revised operating cash flow	$ 267,846	$ 249,870	$258,332
Percent Revision	16.2%	23.7%	15.8%
Olin Corp.:,			
Reported operating cash flow	$ 116,100	$(134,700)	$ 278,900
Adjustment	8,100	9,400	31,000
Revised operating cash flow	$ 124,200	$(125,300)	$ 309,900
Percent Revision	7.0%	7.0%	11.1%
Quicksilver Resources, Inc.			
Reported operating cash flow	$ 49,602	$ 84,847	$ 144,468
Adjustment	734	48	533
Revised operating cash flow	$ 50,336	$ 84,895	$ 145,001
Percent Revision	1.5%	0.1%	.4%
Ruby Tuesday, Inc.:			
Reported operating cash flow	$ 152,925	$219,108	$183,144
Adjustment	703	876	1,734
Revised operating cash flow	$ 153,628	$219,984	$184,878
Percent Revision	.5%	.4%	.9%
Schnitzer Steel Industries, Inc.[a]:			
Reported operating cash flow	$ 40,937	$ 73,221	$ 73,499
Adjustment	286	953	72,833
Revised operating cash flow	$ 41,223	$ 74,174	$146,332
Percent Revision	.7%	1.3%	99.1%
United Refining Co.:			
Reported operating cash flow	$ 5,392	$ 26,541	$ 34,292
Adjustment	2,000	400	--
Revised operating cash flow	$ 7,392	$ 26,941	$ 34,292
Percent Revision	37.1%	1.5%	0.0%
Universal Security Instruments, Inc.:			
Reported operating cash flow	$ (293)	$ (1,098)	$ 1,766
Adjustments	--	727	1,100
Revised operating cash flow	$ (293)	$ (371)	$ 2,866
Percent Revision	0.0%	66.2%	62.3%

[a]On July 18, 2006 Schnitzer Steel announced that it would file an amended Form 10-K and reclassify its cash flow statement moving joint venture distributions from investing to operating cash flow.

Classification Inquiries and Responses

The information provided to this point on possible misclassifications of cash distributions received from equity-accounted investments does little to explain why this may be done. It is, of course, somewhat counterintuitive for firms to take steps to understate operating cash flow. As a result, we sought direct input from firms to provide insight into the reasons for their classification decisions. This input, while somewhat difficult to obtain, does provide some insight not otherwise available by simply reviewing financial statements and their associated disclosures.

We sent letters to 47 of the 107 sample firms and received 14 replies, a response rate of 30% (14 out of 47). Three responses were from operating cash flow-only firms, eight from investing cash flow-only firms, and four from firms that classified distributions received into both operating cash flow and investing cash flow. In some cases our letters sought clarification when the classifications seemed unclear. Others sought explanations for classification decisions or affirmation of inferences drawn by the authors about the classifications.

Relevant information from the responses is summarized in Exhibit 5. For each entry the substance of the response is provided. However, some modifications are made to improve clarity or to maintain the confidentiality of the respondent. The responses are grouped by the three classification categories: operating cash flow firms, investing cash flow firms, and firms including distributions in both operating cash flow and investing cash flow.

Operating Cash Flow Firms

The theme in the responses from the operating cash flow-only firms, numbers 1 through 3, is that the distributions are returns *on* and not *of* investment. This is consistent with the GAAP requirement that distributions representing returns *on* investment be included in operating cash flow. Notice that responses 1 and 3 indicate that they only recently (after receipt of our inquiry in one of the two cases) changed their classification policy and now include in operating cash flow distributions previously included in investing cash flow. Response 2 indicates that distributions classified into operating cash flow are linked to a measure of cash flow as opposed to earnings. Since the cash flow is greater that the equity earnings, the distributions classified into operating cash flow could exceed the return *on* investment.

Investing Cash Flow Firms

The responses from the investing cash flow-only firms, numbers 4 through 11, include several that appear at odds with the GAAP requirement that only returns *of* investment be classified into investing cash flow. Responses 4, 5, 7, and 11 take the position that since distributions are the product of investments they should be classified as investing cash flow. Such a position would appear to be at odds with GAAP. The firms understate operating cash flow to the extent that some or all of the distributions received represent returns on investment. Moreover, the long-term character of the investment cited in Response 7 is not a basis for the exclusive classification of distributions into investing cash flow. It is notable that response 7 cites "a more conservative presentation of cash flow from operations" in support of its investing cash flow classification. The understatement of operating cash flow is a misstatement and is not justified by the invocation of conservatism.

Responses 6, 8, and 10 each reflect a degree of uncertainty about their current investing cash flow classification policy. The firm providing response 9 believes that the distributions received are returns of investment. However, the equity earnings recognized by this firm during the period 2003 to 2005 are more that twice as large as the distribution received during this period. This would seem to provide the basis for some or all of the distribution to be classified into operating cash flow.

Operating and Investing Cash Flow Firms

Responses 12 through 14 are from firms that classified distributions into both operating cash flow and investing cash flow. Response 12 highlights the fact that a distribution is properly classified into operating cash flow in the absence of current equity earnings if sufficient undistributed earnings remain from previous profitable years. Response 13 cites some GAAP-related support for viewing classification into operating cash flow as the default classification. Response 14 notes that an investing cash flow classification is proper in cases where distributions reflect a return of capital.

Exhibit 5: Management Responses to Classification Inquiries

Classifications made into operating cash flow only

1. We classify the receipt (distribution) this year under operating activities due to the basis of it being a return on investment. In the past, it hasn't always been so clear for us, but we now feel that the return on investment is the preferred classification for us since the earnings from the affiliate have surpassed the level of returned funds. It was a bit hard to grasp that an *investment* was generating operating cash, but we prefer to stick with GAAP over our feelings. If our affiliate were not generating earnings in the future, then we would consider cash received to be a return of investment, pushing it back to investing activities.

2. In our case the earnings are typically going to be lower than the distributions due primarily to the impact of non-cash items on the earnings of JVs (joint ventures) such as depreciation at the JV level.

3. I refer you to our 10Q for the period ended June 30th, 2005. In that report you will notice that the distributions received from unconsolidated affiliates have been properly reclassified into the operating category of the Cash Flow Statement, as they do represent dividend distributions rather than returns of capital.

Classifications made into investing cash flow only

4. Consistent with industry practice, we have historically treated both the additional investment in and the distribution from investments in unconsolidated partnerships as investing activities. These investments are not considered part of our underlying operations and during their start-up stage we are required to fund through additional cash contributions a significant portion of the operating and capital requirements of the partnerships.

5. Distributions of dividends, when received, are shown as cash provided by investing activities in our cash flow statement, as we received the cash from our investing activities, an investment in our affiliate.

Exhibit 5 (continued)

6. Your question regarding the classification of distributions from our joint venture is an excellent one. It brings to mind that now famous response by then President Clinton, It depends on what your definition of is is. Or in our case, what the definition of a return *on* investment as opposed to a return *of* investment is.

7. We have elected not to characterize any dividends from joint ventures as operating, as we consider those investments to be long-term in nature and we have not determined for financial statement purposes which of the dividends are returns on investment versus returns of investment. This results in a more conservative presentation of cash flow from operations.

8. After reviewing the accounting literature and other company filings, I have found that there are various treatments followed by companies in reporting distributions received from equity investments in the statement of cash flows. We are taking your question (why in the face of substantial income from equity-accounted investments none of the distributions received was classified into operating cash flow) into consideration and will determine if reclassifying as an operating activity is appropriate.

9. Paragraph 16 of SFAS 95 states that "cash inflows from investing are receipts from sales of equity instruments of other enterprises and from returns *of* investment in those instruments." We believe that income from joint ventures is a return of our investment.

10. Based on our history with the joint venture, there is certainly no assurance of realization of the earnings. Accordingly, when we received our first real cash distribution we viewed the payment as a return *of* investment. I am in no sense suggesting that our classification is absolutely correct. If after considering the above information, you would reach a different conclusion, we would be interested in your opinion.

11. The receipt of dividend distributions is credited to investment in affiliate in the balance sheet and correctly shown as cash provided by investing activities in our statement of cash flows since we received the cash from our investing activities, i.e., an investment in our affiliate. We feel that the disclosure of our share of income or loss and dividends received is proper. This treatment has been approved by our outside audit firm.

<u>Classifications made into both operating and investing cash flow</u>

12. Our decision to include the $10 million as a cash flow from operating activities as opposed to a cash flow from investing activities is due to the nature of the payment received. While you are correct in stating that we had a history of losses on this investment, it also has a strong history of profitability.

13. It is important also to note that when cash is received by an investor from an equity method investee, the presumption exists that this cash is return on investment and should be classified as cash from operations. That presumption can be overcome based on the specific facts and circumstances (*Technical Questions and Answers* (TIS), Section 1300, para. 18).

14. We do in fact classify and include in operating cash flow all dividends received from non-consolidated affiliates. Such dividends are netted against the earnings or losses of the affiliates, and reported on the line, Earnings/losses of unconsolidated affiliates in excess of dividends received. Reported in the investing activities section of the statements are other distributions (not dividends) from these same affiliates. Return of capital, for example, would be such an item.

Conclusion

Most of the sample firms in this study classify distributions received from unconsolidated affiliates as operating cash flow. This seems proper and consistent with GAAP because most of these firms have recognized equity earnings from these investments that equal or exceed the distributions received. That is, the distributions are returns *on* investment. About an equal number of firms, 19 and 18 respectively, classify distributions as investing cash flow only or a combination of operating cash flow and investing cash flow. Firms that classify distributions into both operating cash flow and investing cash flow are clearly making an effort to distinguish between distributions that represent returns *on* investment as opposed to returns *of* investment. However, we find most of the investing cash flow-only classifications to be problematic. The equity earnings during 2003 to 2005 of most of the investing cash flow-only firms exceeded the distributions received. This excess of equity earnings over distributions received suggests that these distributions should have been classified as operating cash flow. Revisions of the reported operating cash flow of the investing cash flow-only firms, to include all of the distributions received, reveal understatements of operating cash flow that appear to be material in many cases, averaging 15.8%. In addition, responses to our inquiries received from firms that classify distributions into investing cash flow makes it clear that distributions that are returns on investment are not being classified into operating cash flow.