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A Re-examination of Cashflow Reporting in the Presence of Overdrafts

Executive Summary

Numerous companies maintain cash overdraft balances. These seemingly innocuous accounts can have material effects on reported amounts of cash and operating cash flow. In this report, updated from the original published in January, 2003, we survey reporting practices for overdrafts and draw attention to cases where analysts may be misled.

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DuPree Financial Analysis Lab

The DuPree Financial Analysis Lab conducts independent stock market research. Independent and 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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A Re-examination of Cash Flow Reporting in the Presence of Overdrafts

Introduction

We originally released our report on overdraft financing in January, 2003 using data for 2000 and 2001. In this report we update our original findings and provide new examples using 2002 data.

Cash-balance overdrafts arise when checks written and presented for payment exceed available bank balances. It is not uncommon for companies to have overdraft protection arrangements with their banks whereby short-term financing is provided to cover checks presented for payment. Indeed, an overdraft arrangement can play a role in effective cash management as a means of minimizing the opportunity cost of carrying funds in low-yielding bank accounts.

At period's end, even though an overdraft has been covered resulting in a positive bank balance, the existence of outstanding checks will result in a book overdraft - a negative cash balance. Generally accepted accounting principles (GAAP) call for the reporting of such an overdraft balance as a current liability.

Consider, for example, the following statement made in the footnotes to the 2002 annual report of The Williams Cos., Inc.:

Note 10. Accounts Payable and Accrued Liabilities

Under Williams' cash-management system, certain subsidiaries' cash accounts reflect credit balances to the extent checks written have not been presented for payment. The amounts of these credit balances included in accounts payable are approximately \$59 million and \$30 million at December 31, 2002 and 2001, respectively.

Reclassifying an overdraft balance to a liability results in an increase in the reported cash balance from a negative amount to zero. At times, the amounts of these reclassifications can be significant. Analysts who are unaware of such reclassifications may be misled into thinking that more on-hand cash is available than is actually the case. Also, while GAAP calls for the reporting of changes in overdraft balances as financing sources and uses of cash, there are companies who report them as operating cash flows. The end result may be an improper assessment of a firm's ability to generate sustainable cash flow.

This report provides accounting guidance for overdrafts and statistics on the extent to which cash overdrafts are reported and their materiality to existing cash balances. Also provided are measures of the extent to which the operating cash flow designation for changes in overdrafts is employed versus a more appropriate financing classification.

Frequency of Overdraft Reporting

We began our original study by gathering evidence on the frequency with which companies report overdraft balances. In our original study we sampled 2,571 10-K annual report filings spread across the fiscal 2001 filing year. In particular, we were looking for evidence of the disclosure of overdrafts either in the footnotes, the balance sheet, or in the statement of cash flows. In the sample, 100 companies, or 3.9% disclosed the existence of overdrafts of a sufficiently material amount to warrant disclosure.

Quick Stat.: 3.9% of 10-K filings sampled reported the existence of material overdrafts

* from original study

Exhibit 1 presents reported cash balances, cash overdrafts, and net cash balances, for a sample of companies noted in our original study, updated with new companies and new data noted for 2002, when available. In the exhibit, the Reported Cash Balance column is the amount of cash and cash equivalents reported on the balance sheet for the fiscal year noted. The Cash Overdraft Balance column is the year-end amount of overdrafts disclosed in the footnotes or as a liability on the balance sheet. The Net Cash Balance was computed by subtracting the overdraft balance from the reported cash balance. Net cash reflects the actual on-hand amount of cash and cash equivalents in the absence of any overdraft financing.

Exhibit 1. Cash Balances and Cash Overdrafts

Company	Year Ended	Reported Cash Balance	Cash Overdraft Balance	Net Cash Balance
AIRBORNE, INC.	12/31/00	\$ 40,390,000	\$ 51,738,000	(\$ 11,348,000)
	12/31/01	210,500,00	25,531,000	184,969,000
	12/31/02	339,900,000	29,705,000	310,195,000
AMC ENTERTAINMENT, INC.	3/29/01	34,075,000	35,157,000	(1,082,000)
	3/28/02	219,432,000	31,751,000	187,681,000
AMGEN INC.	12/31/00	226,500,000	101,200,000	125,300,000
	12/31/01	689,100,000	0	689,100,000
	12/31/02	1,851,700,000	0	1,851,700,000
ANHEUSER-BUSCH COMPANIES	12/31/01	162,600,000	92,300,000	70,300,000
	12/31/02	188,900,000	87,400,000	101,500,000
AVIALL, INC.	12/31/01	2,526,000	7,500,000	(4,974,000)
	12/31/02	4,997,000	34,220,000	(29,223,000)
BOEING CORP.	12/31/01	633,000,000	351,000,000	282,000,000
	12/31/02	2,333,000,000	301,000,000	2,032,000,000
COX COMMUNICATIONS, INC.	12/31/01	86,860,000	90,700,000	(3,840,000)
	12/31/02	228,704,000	66,800,000	161,904,000
DELTIC TIMBER CORP.	12/31/01	6,122,000	0	6,122,000
	12/31/02	1,057,000	913,000	144,000

Exhibit 1 (continued). Cash Balances and Cash Overdrafts

Company	Year Ended	Reported Cash Balance	Overdraft Balance	Net Cash Balance
EASTMAN CHEMICAL CO.	12/31/01	66,000,000	69,000,000	(3,000,000)
	12/31/02	77,000,000	39,000,000	38,000,000
ELECTRIC LIGHTWAVE INC.	12/31/00	10,318,000	6,965,000	3,353,000
	12/31/01	5,285,000	1,887,000	3,398,000
HERSHEY FOODS CORP.	12/31/01	134,147,000	26,500,000	*134,147,000
	12/31/02	297,743,000	24,800,000	*297,743,000
HUNT CORP.	12/03/00	23,878,000	4,100,000	19,778,000
	12/02/01	25,966,000	2,600,000	23,366,000
KENDLE INTER., INC.	12/31/00	6,709,000	1,234,000	5,475,000
	12/31/01	6,016,000	503,000	5,513,000
	12/31/02	12,671,000	101,000	12,570,000
LIMITED BRANDS, INC.	02/02/02	1,495,000,000	120,000,000	1,375,000,000
	02/01/03	2,262,000,000	161,000,000	2,101,000,000
MEDSOLUTIONS, INC.	12/31/01	0	145,500	(145,500)
	12/31/02	0	87,588	(87,588)
NATIONAL R.V. HOLD., INC.	12/31/01	22,000	608,000	(586,000)
	12/31/02	14,000	943,000	(929,000)
OPTIMAL ROBOTICS CORP.	12/31/01	9,616,430	98,390	9,518,040
	12/31/02	9,615,348	0	9,615,348
ORTHODONTIC CENTERS OF AMERICA, INC.	12/31/01	14,172,000	3,992,000	10,180,000
	12/31/02	7,522,000	2,211,000	5,311,000
PAVING STONE CORP. & SUBS.	12/31/01	35,439	326,936	(291,497)
	12/31/02	15,639	78,393	(62,754)
PEABODY'S COFFEE, INC.	03/31/02	7,307	48,495	(41,188)
	12/31/02	59,357	0	59,357
PERINI CORPORATION	12/31/01	9,512,000	2,626,000	6,886,000
	12/31/02	47,031,000	0	47,031,000
RAILWORKS CORP.	12/31/00	7,138,000	16,766,000	(9,628,000)
	12/31/01	2,830,000	2,995,000	(165,000)
	06/31/02	1,238,000	1,269,000	(31,000)
SPEIZMAN IND. INC. & SUBS.	06/30/01	0	1,438,466	(1,438,466)
	06/29/02	970,000	0	970,000
STRATEGIC DISTRIB. INC.	12/31/00	1,869,000	2,495,000	(626,000)
	12/31/01	3,614,000	0	3,614,000
	12/31/02	43,622,000	2,090,000	41,532,000
US XPRESS ENTERPRISES, INC.	12/31/01	8,185,000	0	8,185,000
	12/31/02	131,000	6,437,000	(6,306,000)
THE WILLIAMS COS., INC.	12/31/01	1,258,500,000	20,000,000	1,238,500,000
	12/31/02	1,728,300,000	59,000,000	1,669,300,000

Source: Company filings with the SEC.

Quarterly filing - only data available.

*In 2001 and 2002, Hershey Foods netted overdrafts against other positive cash balances, reporting cash net of overdrafts.

In reviewing Exhibit 1, consider the overdraft balances carried by Anheuser-Busch Companies. At December 31, 2002, the company reported a cash balance of \$188.9 million. That amount of cash was bolstered, however, by an overdraft balance of \$87.4 million. After deducting the overdraft balance, the company's actual cash on hand was \$101.5 million.

Anheuser-Busch described its overdrafts as outstanding checks - checks written in excess of available cash balances. As disclosed in the notes accompanying the company's 2002 annual report, outstanding checks were reclassified to accounts payable:

Accounts payable include \$87.4 million and \$92.3 million, respectively, of outstanding checks at December 31, 2002 and 2001.

As in prior years, Aviall, Inc. continued to carry a substantial overdraft balance. At December 31, 2002, the company reported a cash balance of \$4,997,000. Supporting its cash, however, was an overdraft balance of \$34,220,000. As a result, the company's actual cash on hand was a negative balance of \$29,223,000. To their credit, in their 2002 statement of cash flows, Aviall did change the classification of cash provided by overdrafts to a more representative financing designation from an operating one. In a subsequent section we provide additional information on the classification of overdrafts in the statement of cash flows.

At the end of 2002, relative to cash on hand, US Xpress Enterprises, Inc. also carried a significant overdraft balance. At December 31, 2002, the company reported cash of \$131,000. However, that balance was after adding overdraft financing in the amount of \$6,437,000. The company's actual cash balance at the time was a negative balance of \$6,306,000.

US Xpress Enterprises was forthcoming with its disclosure of its overdraft balance. Unlike many companies that group overdrafts with accounts payable, on its balance sheet US Xpress reported a line item, book overdraft, within current liabilities.

In 2001, Hershey Foods Corp. changed its reporting of overdrafts. Previously they had been included with accounts payable. Starting in 2001 the company began netting overdrafts against its reported cash balance. Consider the following statement provided in the footnotes to Hershey's 2002 annual report:

Short-term debt

As a result of maintaining a consolidated cash management system, the Corporation maintains overdraft positions in certain accounts at several banks. The Corporation has the contractual right of offset for the accounts with overdrafts. Such overdrafts, which were reflected as a reduction to cash and cash equivalents, were \$24.8 million and \$26.5 million as of December 31, 2002 and 2001, respectively.

Even after subtracting overdraft balances, several companies in our survey improved their cash balances in 2002 from 2001. Consider, for example, Cox Communications, Inc., whose net cash

balance increased to \$161,904,000 at December 31, 2002 from a negative balance of \$3,840,000 in 2001. Similarly, Eastman Chemical Co. improved its net cash balance to \$38,000,000 at December 31, 2002 from a negative \$3,000,000 in 2001, and Hershey Foods Corp. increased its net cash balance to \$297,743,000 at December 31, 2002 from \$134,147,000 in 2001.

Overdrafts and the Statement of Cash Flows

Under GAAP, changes in overdraft balances - sources of cash from increasing overdraft balances or uses of cash from reducing them - should be reported as financing activities on the statement of cash flows. Statement 95, *Statement of Cash Flows*, does not make specific reference to the cash flow classification of overdrafts. The Statement is, however, clear in noting that outside sources of cash in the form of borrowed amounts are to be classified as financing activities. Because cash is not on-hand to fund an overdraft balance, an outside source, a financing, is needed. Supporting this view, in a speech delivered to the Twenty-Third Annual National Conference on Current SEC Developments in 1996, Christine Q. Davine, Associate Chief Accountant, Division of Corporation Finance of the SEC noted,

"Registrants are reminded to evaluate the criteria in SFAS 95 for classifying each cash receipt and payment in the appropriate category . . . Cash overdrafts should be reported as financing activities."¹

In some instances, companies may use funds transferred from company-owned investment accounts to cover overdrafts. In such cases, an investing cash-flow classification for changes in overdrafts, though importantly, not an operating designation, would appear to be in order. When it reported overdrafts in 2000, Amgen, Inc. had just such an arrangement.

Such guidance notwithstanding, not all companies report changes in overdrafts outside the operating section of the cash flow statement. In fact, among the sample of companies in our original study reporting the existence of overdrafts, 16% included changes in overdrafts as operating cash flow while 61% reported overdrafts in the financing section. The remainder, 23% of our sample, did not provide sufficient information to determine where overdrafts had been classified in the statement of cash flows.

Quick Stats.: 16% of sample reported overdrafts in operating cash flow

61% of sample reported overdrafts in financing cash flow

* from original study

In analyzing performance, it is important to be clear on how overdrafts have been classified on the statement of cash flows. When overdrafts are included in operating cash flow, analysts may overestimate the amount of sustainable cash flow being generated. Given the nontrivial number

¹ "American Institute of Certified Public Accountants 1996 Twenty-Third Annual National Conference on Current SEC Developments," taken from <http://www.sec.gov/news/speech/speecharchive/1996/spch080.txt> (accessed 10/28/02).

of firms classifying overdrafts as operating cash flow, there is ample opportunity for analysts to be misled.

Exhibit 2 provides a list of companies and the amount of cash flow provided or (used) in operations by the change in overdraft balances. Companies with noted overdraft balances that do not appear in Exhibit 2 either reported overdrafts as financing cash flow or, as in the case of Boeing Corp. and Limited Brands, Inc., provided insufficient information for us to determine where overdraft financing was classified on the statement of cash flows.

Exhibit 2. Overdrafts and Operating Cash Flow

Company	Year Ended	Operating Cash Flow Provided (Used) by Overdrafts
AIRBORNE, INC.	12/31/01	\$(26,207,000)
	12/31/02	4,174,000
ANHEUSER-BUSCH COMPANIES	12/31/02	(4,900,000)
ELECTRIC LIGHTWAVE, INC.	12/31/01	(5,078,000)
MEDSOLUTIONS, INC.	12/31/02	(57,912)
NATIONAL R.V. HOLDINGS, INC.	12/31/02	335,000
OPTIMAL ROBOTICS CORP.	12/31/02	(98,390)
ORTHODONTIC CENTERS OF AMERICA, INC.	12/31/02	(1,781,000)
PAVING STONE CORP. & SUBS.	12/31/02	(248,543)
PEABODY'S COFFEE, INC.	12/31/02	(48,495)
PERINI CORP.	12/31/00	4,739,000
	12/31/01	(3,463,000)
	12/31/02	(2,626,000)
SPEIZMAN IND., INC.	6/29/02	(1,438,000)
STRATEGIC DISTRIBUTION, INC.	12/31/01	(2,495,000)
	12/31/02	2,090,000

Source: Company filings with the SEC. Quarterly filing - only filing available.

In reviewing Exhibit 2 it is important to note that it is the change in the overdraft balance that affects operating cash flow. An increase in an overdraft balance increases operating cash flow, a decrease reduces it.

Many companies did not explicitly disclose the effects of overdrafts on operating cash flow. Rather, they included overdrafts with accounts payable, which is reported as an operating item. Among the firms using this reporting approach were Airborne, Anheuser Busch, Orthodontic Centers of America and Strategic Distribution. In these cases we were able to reasonably conclude that the change in accounts payable, including cash overdrafts, was included in operating cash flow.

Interestingly, as a result of declines in overdraft balances, many companies actually reported lower operating cash flow than they would have had overdrafts been reported as a financing activity. Included in this list are such firms as Anheuser Busch and Orthodontic Centers of America. However, it is important to note that operating cash flow will be increased in the future if these companies were to increase their overdraft balances.

During 2002, Airborne reported an operating source of cash of \$4,174,000 from an increase in its overdraft balance. Strategic Distribution reported a similar source of cash of \$2,090,000 in 2002.

Since our last report, Aviall, Inc. changed the cash flow classification of its overdrafts to a financing designation from an operating one. Recall that in 2000, Aviall, Inc. reported that it generated \$7,668,000 in operating cash flow. However, that year, an increase in overdrafts from \$4,500,000 in 1999 to \$19,700,000 in 2000, provided \$15,200,000 in operating cash flow. In the absence of overdraft financing, the company would have consumed cash in operations. In 2001, Aviall, Inc. reported that it used \$93.4 million in cash from operations. That year, a decline in overdrafts consumed \$12.2 million in operating cash flow.

The company changed its reporting practices in 2002. That year Aviall began clearly reporting the amount of funds provided from changes in overdraft balances in the financing section of its statement of cash flows. Cash flow statements for 2000 and 2001 were restated to move overdraft-related cash flows to the financing section. For the year ended December 31, 2002, Aviall's operations used \$37,084,000 in cash flow. Helping to fund that cash flow need was a substantial use of cash overdrafts, reported in the financing section of the cash flow statement, in the amount of \$26,720,000.

Reduced Disclosure of Overdrafts

During 2002 we saw examples of companies that discontinued disclosure of overdraft balances. For example, in the first quarter ended March 2002, Mim Corp. reported that of \$12,931,000 generated by operations, \$9,698,000 came from overdraft financing. However, the company did not disclose the amount of its overdraft financing for the fiscal year ended December 2002. It is possible that the company discontinued use of overdraft financing as the year 2002 progressed.

Overdraft Facilities

Another finding from our recent research was the prevalence of “overdraft facilities” created to provide regular overdraft financing. In most instances, the footnotes provide detailed disclosure regarding the structure and overall dollar size of the facilities. Unfortunately, very few companies provided the overdraft balances needed for an in-depth analysis. An example of an overdraft facility disclosure is provided below for Aon Corporation in the notes of its 2002 annual report.

Guarantees and Indemnifications

A bank provides overdraft facilities for certain of Aon's foreign subsidiaries. Aon has guaranteed repayment of this facility in the unlikely event that the foreign subsidiaries are unable to repay. Aon has also issued guarantees and/or other letters of support for various bank lines, and various other credit facilities for certain of its foreign operations (including the Euro credit facility discussed in note 8 to the consolidated financial statements). Aon's maximum potential liability with regard to these exposures was \$160 million at December 31, 2002.

Selected companies that disclosed Overdraft Facilities include:

Aon Corporation
Brightpoint Corporation
Digital Video Systems Inc.
Dura Automotive Systems Inc.
Hercules, Inc.
Katy Industries
Owens Illinois Group Inc.
Russ Berrie & Co Inc.
Sitel Corporation
Trikon Technologies, Inc.

Conclusion

The presence of overdraft balances at year-end can affect the presentation of both the balance sheet and statement of cash flows. Because overdraft balances are typically classified as liabilities, the reported balance in cash can be misleading. Moreover, if changes in overdraft balances are improperly reported in the operating section of the cash flow statement, reported operating cash flow does not clearly reflect sustainable cash flow. Given the number of companies maintaining overdraft balances and the potentially material effect such overdrafts can have on cash balances and operating cash flow, a complete financial analysis should consider their impact.