**WHAT’S UP WITH CASH BALANCES?**

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The past decade has yielded a growing number of cases of cash reporting problems among global firms. According to Audit Analytics, corporate restatements in the United States for cash-related reporting soared from 0.49 percent of all restatements in 2001 to over 13 percent in 2008. Between 2002 and 2005, Grant Thornton auditors failed to detect cash frauds totaling almost €4 billion at Parmalat, a global Italian dairy and food corporation. In 2008, PricewaterhouseCoopers’ auditors missed a £1 billion in fraudulent cash balances at Satyam, the Indian technology outsourcing giant. What’s going on?

Historically, cash has not been that hard to audit or report, and junior accountants in their first and second years have routinely been tasked with auditing balances and preparing disclosures for these assets. After all, how hard can it be to audit and report cash assets, when verification and valuation generally are not issues?

Why aren’t companies reporting cash in an ethical and transparent manner? As analysts’ concern with earnings management has grown, they are devoting more attention to reported cash flows. Global financial managers are aware of this new focus and have responded accordingly by either creatively or intentionally misreporting corporate cash flows.

Initially, most of the gimmickry related to inflating operating cash flows (OCF) by simply misclassifying cash flows in the statement of cash flows (SCF). Investing or financing cash inflows are reported as operating activities, and operating cash outflows are included in the investing and financing sections of the SCF. While such games continue even today, corporate accountants continue to develop more sophisticated schemes to artificially inflate cash balances and related flows. Managers now commonly achieve OCF targets via asset liquidations, by delaying payments on payables, and even by counting receivable collections as cash before they are actually received, and employing special purpose entities.

Note the following 8-K disclosure recently filed by Orbitz Worldwide, a leading global online travel company:

*The Company determined that credit card receipts in-transit at its foreign operations (which are generally collected within two to three days) should have been classified as “Accounts Receivable” rather than “Cash and Cash Equivalents.”*

The Pep Boys, a large U.S. automobile parts, tire, and service provider, also reported the following in its 10-K:

*All credit and debit card transactions that settle in less than seven days are also classified as cash and cash equivalents.*

Such practices clearly raise questions about the quality of reported cash balances and OCF, and recently the games have reached an all time low. Managers now have decided to simply change the way they define cash in the balance sheet. Every accounting student learns that a company reports as cash on their end-of-period balance sheet the amount reflected in the company’s general ledger; however, a growing number of companies are abandoning this generally accepted practice and now inflate their reported balance sheet cash flows by adding back outstanding checks (i.e., those than have not yet cleared the bank) written and mailed before period-end. This practice not only increases reported cash balances, but also overstates OCF since the outstanding checks are added to accounts payable. Note the following example from the recent 10-K of Dick’s Sporting Goods, a national U.S. sporting retailer:

*Accounts payable at January 30, 2010 and January 31, 2009 include $74.2 million and $74.8 million, respectively, of checks drawn in excess of cash balances not yet presented for payment.*

In this case, OCF were overstated by 89.16 percent in 2009 and 22.68 percent in 2010. Then there is the case of Airgas, a nationwide distributor of gases, welding supplies, safety products, and tools, that reports in its 2010 10-K:

*Cash principally represents the balance of customer checks that have not yet cleared through the banking system…Cash overdrafts represent the balance of outstanding checks and are classified with other current liabilities.*

In this case, had the company reported its outstanding checks appropriately, its cash balance would have been negative at the end of 2010, and its OCF were overstated by $5.5 million as well.

These practices constitute reprehensible accounting. At best, these outstanding check cash balances are not available for use and should not be reported as current assets. They are restricted, and therefore, should be reported as non-current assets. But even that treatment is a stretch.

Once again we ask: where are the auditors? In this case, maybe the auditors don’t know what they’re doing. Junior accountants, who typically are given this assignment, may no longer be qualified to handle cash audits or reporting. As global cash transactions have become increasingly complex, both the familiarity and training of accountants in the cash area may have actually declined. Most young adults no longer keep check books, and consequently, no longer perform the reconciliation process on their personal accounts. Instead, they simply check available balances either online or at an automatic teller machine, and adjust their spending habits accordingly.

Additionally, accounting education has minimized the importance of the bank reconciliation. Many intermediate financial accounting authors have relegated the topic to a few pages in an appendix, and most auditing texts completely ignore the proof-of-cash tool that historically proved so valuable in detecting cash frauds. One has to read a forensic accounting text to find anything substantive about the issue, and that course is still missing from the curriculum of many schools.

Given these lifestyle and pedagogical developments, coupled with corporate manager misreporting behaviors, it may be time to revisit who really should be auditing cash and reviewing company disclosures. In the meantime, the SEC might consider investigating firms who defraud investors with phony numbers in the cash account.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*