Today’s Content

• The Statement of Cash flows
  – Cash inflows and outflows
  – From operations … internal activities
  – From financing & investing … external activities
  – Cash flow analysis
The Statement of Cash Flows

- The Statement of Cash Flows
  - The “statement of cash inflows & outflows” during an accounting period
  - A VERY important financial statement for determining the health of a company
    - Analysts are very aware that a company can post a good looking Income Statement but not have the cash flow necessary to pay its employees, suppliers, and lenders

Categories of cash flows:
- Cash flows from operations
  - From “internal activities”
- Cash flows from investing & financing
  - From “external activities”
- Reconciles all balance sheet accounts to changes in the “cash & cash equivalents” accounts for more than one acctg. period
  - Calculation is rather counter-intuitive
    - Leave the calculation details to the accountants

Logic Behind Cash Flows

- Assets = Liabilities + Stockholder’s Equity
  - Asset accounts (other than cash & cash equiv.)
    - Accounts receivable … Inventory … Property, plant & equipment … Long term investments
    - Operating: Accounts receivable … Inventory
    - Investing: Property, plant & equipment … Long term investments
  - Liability & equity accounts
    - Accounts payable … Long-term debt … Stockholder’s equity
    - Operating: Accounts payable
    - Financing: Long-term debt … Stockholder’s equity
Cash Flow from Operations

• Operating activities:
  – Cash inflows = Sales + Collection of revenue from services + Returns on investments (interest & divs.)
  – Cash outflows = Payments for inventory, salaries, rent, goods & services + Payments to lenders + Payments of taxes

What happens to cash when inventory is sold?
• Cash inflow occurs if items are sold for cash
• Increase in accounts receivable occurs if items are sold on credit

What happens to cash when items are purchased or bills are paid?
• Cash outflow occurs if paid for in cash
• Increase in accounts payable or debt occurs if purchased on credit

Cash Flows from Investing

• Investing activities:
  – Cash inflows = Sale of property, plant & equipment + Sale of debt or investment securities + Returns from loans (principal) to others
  – Cash outflows = Buying property, plant & equipment + Purchase of debt or investment securities + Loans (principal) to others
Cash Flows from Investing

• What happens to cash when the company sells property or investment securities?
  – Cash inflow occurs if items are sold for cash
• What happens to cash when the company buys long term assets?
  – Cash outflow occurs if paid for in cash
  – Increase in debt occurs if purchased on credit

Cash Flows from Financing

• Financing activities:
  – Cash inflows = Cash proceeds from borrowing + Cash proceeds from issuing stock
  – Cash outflows = Repayment of debt principal + Repurchase of company’s own stock + Payment of dividends on stock

Cash Flows from Financing

• What happens to cash when the company borrows from a bank or issues stock?
  – Cash inflow
• What happens to cash when the company repays debt principal or declares cash dividends?
  – Cash outflow
Analysis of Cash Flows

• Analysis of the Statement of Cash Flows is very important in order to determine a company’s financial health
  – The statement can tell you whether the company is going to:
    • Generate cash flows in the future
    • Meet its obligations for cash
    • Need external financing
  – As well as the success of its financing and investing activities

Cash Flows

• Managers must always be aware of their cash flow situation
  – Cash flow from operations is a critical measure
    • Cash shortfalls can be covered temporarily through borrowing (financing)
    • And cash from investments can help
    • But eventually, the company must generate sufficient cash from operations

Cash Flow Analysis

(Example 1)

• What if managers are evaluated on increases in sales/revenues as measured on the Income statement?
  – Managers could show increased sales/revenues by extending more credit to customers (liberalizing credit policies)
    • The result would be increased sales/revenues but also increased accounts receivable, more of which would be uncollectible, and therefore lower cash flow
Cash Flow Analysis
(Example 2)

• What if managers are evaluated on improving net income?
  – Managers could play games using non-cash expenses such as depreciation:
    • Switching to a different method of depreciation, which would lower depreciation expense and raise net income but not improve cash flow
    • Sell assets, which would lower depreciation expense and raise net income and improve cash flow

Cash Flow Analysis

• What if you were considering taking on a business partner?
  – Some important cash flow related questions you should ask:
    • Is the company consistently generating cash flows from operations
    • Does the company’s operating cash flow fluctuate significantly from year to year … how are the fluctuations handled

Summary

• The Statement of Cash Flows
  – Reconciles the Cash accounts on the Balance Sheet for more than one year
  – Operating cash flows … from internal sources
  – Investing & financing cash flows … from external sources
  – Cash flow analysis to determine real financial health