A LOOK AT THE CORPORATE CASH FLOW STATEMENT

By John Bajkowski

The cash flow statement can give valuable insight into how well a company is managing its growth. Ultimately, firms have to produce cash to do well in the long run.

"Show me the money" is more than a catchy phrase from a movie. Earnings, dividends, and asset values are important factors, but it is ultimately a company's ability to generate cash that fuels the growth in these factors. Strong cash flow allows a company to increase dividends, develop new products, enter new markets, pay off liabilities, buy back shares, and even become an acquisition target. It is important to understand the statement of cash flows and the elements that impact upon cash flow trends.

This fundamentals article is the third in a series on financial statement analysis—how to read and analyze them for stock analysis. The balance sheet was presented in the January 1999 *AAII Journal*, and the income statement in the April 1999 issue. This article will examine the statement of cash flows.

Alternate issues of the *AAII Journal* this year will carry an article exploring the use and interpretation of financial statements. On our Web site, the articles are organized under the heading "Focus on Financial Statements" within the Stocks area (www.aaii.com/stocks). AAII is also publishing member questions and answers related to financial statements. If you have any questions or comments, please E-mail them to financials@aaii.com.

CASH FLOW

Earnings and earnings multiples dominate standard measures of company performance and stock price valuation. However, as we have seen when studying the income statement and balance sheet, slight accounting differences can make it difficult to track earnings over time or between firms. Net income reports on a company's performance under principles of accrual accounting, which attempts to match expenses to revenues when the revenues are recognized.

Accrual accounting introduces many interpretations and estimates by management into the financial statements. Decisions regarding the capitalization of expenses, the recognition of revenue, the creation of reserves against losses, and write-off of assets are examples of just a few of the factors that may vary from firm to firm. Many of these issues are factors that relate to the "quality" of a firm's earnings.

For example, cash used to build up inventory will not be reflected as an expense on the income statement until the inventory is sold. But even the recognition of this inventory cost may vary from firm to firm if one company uses a last in, first out (LIFO) method to measure the cost of inventory sold while another firm uses a first in, first out (FIFO) method. Higher sales may not translate into higher cash flow if accounts receivable is allowed to grow. Prepaid expenses such as income taxes and software development costs may not flow through the income statement when the payments are actually made. On the other hand, much like a personal checkbook, cash accounting tracks cash inflows and outflows directly when they actually occur.

STATEMENT OF CASH FLOWS

Fortunately, companies have been required to provide a statement of cash

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TABLE 1. STATEMENT OF CASH FLOWS

Cash flows from operations (indirect method)		Explanation
Net Income	$ 380	Starting point for determining cash from operations using the indirect method.
Adjustments to reconcile net income to net cash provided by cash activities		
Depreciation	80	Add back, expense involves no cash outflow.
Amortization of goodwill	20	Add back, expense involves no cash outflow.
Income from unconsolidated entities	(5)	Deduct, revenue item does not result in cash inflow.
Increase (Decrease) in deferred taxes	15	Add back, increase in expense involves no cash outflow.
Loss (Gain) on sale of equipment	50	Add back loss, non-operating (should be shown in the cash flow from investing activities).
Changes in current assets and liabilities		
Decrease (Increase) in accounts receivable	(105)	Deduct increase in accounts receivables, actual cash flow from sales is less than accrual sales level.
Decrease (Increase) in inventory	(125)	Deduct increase in cash outflow for inventory increase that exceeds accrual basis inventory cost included in cost of goods sold.
Increase (Decrease) in accounts payable	50	Add increase, cash outflow for purchases is less than accrual purchase cost included in cost of goods sold.
Net cash provided by operating activities	$ 360	Sum of items presented in operating cash flow section.
Cash flows from investing activities		
Acquisitions, net of cash acquired	(400)	Deduct net cash value of cash acquisitions of other firm. If a company raised capital to fund purchase, the proceeds would appear under financing activities.
(Payments) for property, plant, and equipment	(30)	Investments in capital-producing assets are a use of cash.
Proceeds from the sale of assets	50	Add back, sale of assets reflects a reduction in investments.
Distributions from unconsolidated entities	5	Add back, payments from non-operating investments.
Proceeds from notes receivable	300	Add back, sale of note receivable represents sale of investment.
Net cash provided by operating activities	$ (75)	Sum of items presented in investing cash flow section.
Cash flows from financing activities		
Increase (decrease) in notes payable	10	Add back, increase represents issuing additional debt.
Long-term debt issued (retired)	100	Add back, increase represents issuing additional debt.
Increase (decrease) in common stock	(200)	Repurchase of shares is a use of cash and shown as a negative.
Dividends paid	(100)	Payment of dividends is a use of cash and distribution of capital.
Net cash provided by financing activities	$ (190)	Sum of items presented in financing cash flow section.
Effect of exchange rate changes on cash	$ (5)	Activities in foreign currencies translated to dollars.
Net increase (decrease) in cash	$ 90	Sum of cash flow from operations, investing, financing, and currency effect.
Cash at the beginning of year	$ 230	
Cash at the end of year	$ 320	Beginning cash position plus net increase (decrease) in cash.

Bracketed items ( ) represent use of cash

flows since 1987. The purpose of the statement is to disclose information about the events that affected cash during an accounting period. The statement looks at the changes in the levels of cash directly.

A sample cash flow statement is presented in Table 1. The statement divides company uses and sources of cash into three mutually exclusive segments—operating activities, investing activities, and financing activities.

OPERATING CASH FLOW

The operating cash flow segment is designed to measure a company's ability to generate cash from day-to-day operations as it provides goods and services to its customers. It considers factors such as cash from the collection of accounts receivable, the cash incurred to produce any goods or services, payments made to suppliers, labor costs, taxes, and interest payments. A positive cash flow from operations implies that a firm was able to generate enough cash from continuing operations without the need for additional funds. A negative cash flow from operations indicates that additional cash inflows were required for day-to-day operations of the firm.

Companies can determine the cash from operations using either the direct or indirect method. However, the vast majority of companies report operating cash flow using the indirect method, which is presented in Table 1.

Under the indirect method, net income is the starting point for cash flow from operations. Adjustments for non-cash expenses, non-operating income and expenses, as well as changes on the balance sheet attributed to operating activities are presented to reflect the sources and uses of cash beyond profit. Table 1 provides samples and explanations of types of adjustments found on a typical statement of cash flows prepared under the indirect method.

In contrast, under the direct method, the actual operating cash flows are reported for each primary operating segment such as collections received from customers, payments made to employees, payments to suppliers of goods and services such as goods used in inventory and advertising, interest expenses, and taxes. If the cash flows from operations begins with the net income, the company is using the indirect method. However, if the cash flows from operations begins with collections received from customers, the statement is prepared under the direct method.

INVESTING CASH FLOW

The investing segment of the cash flow statement captures changes in a company's investment in the firm. Financial and tangible assets allow the company to produce future profits. Factors such as purchases of property, plant, and equipment; investment or sale of marketable securities; and investments or divestitures in subsidiaries can be recorded in this segment.

The elements displayed in this area will vary depending upon the nature of the industry. Financial firms will use cash to make loans, while industrial firms will have higher cash flows used for property, plant, and equipment.

Purchases and investments are uses of cash, so they are recorded as a negative, while the receipts from the sale of assets represent a source of cash and are reported as a positive figure. Accounting rules dictate that only investments with maturities of three months or less qualify under the definition of cash equivalent. Therefore even the purchase of short-term, near cash instruments can show up as an investment and corresponding use of cash.

Negative cash flow from investing activities indicates that the company made additional long-term investments in the company's assets or outside investments. A positive cash flow from investing activities indicates a divestiture or sale of the long-term assets of the firm.

FINANCING CASH FLOW

The financial segment of the cash flow statement examines how the company finances its endeavors and how it rewards its shareholders through dividend payments. Factors such as cash received from the issuance of new shares of stock or debt, payment of dividends to stockholders, and the cash used to repurchase stocks or to retire debt are summarized by this segment. Note that interest payments are considered part of normal operational expenses and are factored into the operations segment, not the financing segment, of the cash flow statement. Interest income will not appear as a separate line item on the cash flows from operations segment if the indirect method is used, because it is already factored into the calculation of net income. Cash dividends paid to shareholders are considered a return of capital, so they are reported within the financing section.

When it comes to sources and uses of cash, cash inflows include proceeds from issuing stock, notes, bonds, mortgages, and other short-term or long-term borrowing. Cash outflows for financing activities include payments of dividends to owners, repayments of money borrowed, and repurchase of stock.

CURRENCY TRANSLATION

The cash flow statement also includes a separate section that details the impact of foreign currency translation on the company's cash flow. This line item will not appear for companies in which the effect was negligible. However, the line item can be substantial for multi-national companies. General Motors had a positive cash flow of $306 million from currency translation in 1998, but a negative $513 million in 1997.

NET CASH CHANGE

The net cash flow or net increase (decrease) in cash for a company is the sum of operating, investing, and financing activities plus any foreign exchange effects. It indicates whether the company generated or used cash during the reporting period. Normally, the net change in cash is added to the beginning level of cash and cash equivalents to calculate the cash at the end of the period. This cash line will match the cash and cash equivalents reported on the period-ending balance sheet.

OPERATING CASH FLOW VS. NET INCOME

Investors look closely at the operating cash flow because it relates most closely to the income statement and earnings. Both statements should be considered together because each has its own limitations. The cash-oriented accounting of the operating cash flow ignores sales from which money can reasonably be expected in the near term as well as expenses that are owed and must be paid in the future. The accrual-based income statement includes non-cash elements and is affected by management's estimates and discretion of account treatments. The income statement does not show the timing of cash flows and the effect of operations on liquidity and solvency.

For established companies, both cash flows from operations and net income should follow similar trends. The comparison of the operating cash flow segment to the net income statement is less applicable to younger, rapidly growing companies that must use significant levels of cash to fund their growth through increases in items such as accounts receivable and inventory.

FREE CASH FLOW

Ideally, a company should not only cover the costs of producing its goods and services, but also actually produce excess cash flow for its shareholders. Cash flows from operations represents a good starting point for this type of analysis. However, beyond current production, a growing company must reinvest its cash to maintain its operations and expand. While management may neglect capital expenditures in the short term, there are fundamental negative long-term growth implications to such neglect. Free cash flow refines the cash flow from operations measure by subtracting capital expenditures and dividend payments from operating cash flow. While you can argue that dividend payments are not required, they are expected by shareholders and they are paid in cash, so they must be subtracted from cash flow to calculate a free cash flow figure.

This free cash flow figure is considered to be excess cash flow that the company can use as it deems most beneficial. With strong free cash flow, debt can be retired, new products can be developed, stock can be repurchased, and dividend payments can be increased. Excess cash flow also makes a company a more attractive takeover target.

You may need to make adjustments to the free cash flow figure depending upon the company's industry. Financials do not typically have large expenditures in brick and mortar property, plant, and equipment expenditures. However, they make significant investments in marketable securities, which are not considered in the standard free cash flow calculation. When looking at the cash flow of a financial firm, it would be best to examine total cash flow figures from the statement of cash flows.

Cyclical firms and companies with long development and construction cycles may have periods of slow sales, inventory build-up, and strong capital expenditures that occur over the normal course of business. A firm such as Boeing, which has a long development cycle for new planes, a long ramp-up period when starting production, and an extended and expensive product construction cycle, may show negative free cash flow until it starts to deliver its planes in quantity.

CONCLUSION

A firm's cash flows are driven by its sales growth and management's ability to manage expenses, capital investment, and financing in response to that growth. The cash flow statement can give valuable insight into how well a company is managing its growth. Sales, inventory control, production and employee costs, accounts receivable management, interest payment levels, product development, and capital expenditures are some of the elements that impact the cash flow statement. It is critical to understand industry norms to gain a complete understanding of the numbers. Ultimately, firms have to produce cash to do well in the long run.

Now that we have introduced the construction of the three basic financial statements, we are ready to see more closely how they interrelate and how they can be used to help gauge the attractiveness of the firm. In the next Fundamentals article, we will study how ratios can be used to measure elements such as the financial strength of the firm and its management's efficiency.✦