FOUR BASIC STEPS TO GAUGING A FIRM'S TRUE FINANCIAL POSITION

By Jay Taparia, CFA

A basic understanding of a company's "true" financial position can be gleaned by starting with a company's cash flow statement. Four initial steps you can use to analyze a firm's financial statements.

Understanding a company is similar to understanding your own personal finances. In fact, if you look at a company's financial statements, you will find that they are similar to our own "personal" financial statements. However, for most of these, there is a different basis for how items are reported. Table 1 provides a simple analogy.

If you were to analyze your own finances, you typically would start by looking at how much money you have in your checking account and at the transactions posted to your account. This usually represents "the truth" about how you really spent all of your money.

This is very much how analysts look at corporate financial statements—starting with the cash flow statement—to get at "the truth."

This article outlines four basic cash flow analysis steps you can use to better understand a company's financial position.

1: STUDY THE CASH FLOW

The process starts with an understanding of the cash flow statement.

Imagine how a bank investigates you when you're applying for a mortgage to buy your first home. The bank wants to know everything about your income tax filings, bank statements, pay stubs, debt payments and credit score before approving you for a loan. They are looking at your "cash flows" to see how you've really managed your personal cash flows or business.

You should begin looking at a company with the same approach, using the cash flow statement to provide you with a greater sense of how the business model really works—where does cash come from (source of cash) and where does it go (use of cash)?

The cash flow statement has three parts, although the components may vary depending on the type of business the company engages in:

- *Cash flow from operating activities*—describes cash coming in and going out from a company's day-to-day business.
- *Cash flow from investing activities*—describes cash coming in and going out from longer-term purchases, asset sales or investment accounts.
- *Cash flow from financing activities*—describes additional sources of cash coming in or going out from interest paid, interest received, loans, bonds sold or stock issued.

Each of the line items in the cash flow statement indicates whether cash was spent or received. For example, if accounts receivable increased by $100,000, this tells you that there was a use of cash, which will be depicted

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TABLE 1. FINANCIAL STATEMENTS: CORPORATE AND PERSONAL SIMILARITIES

Corporate Statement	Personal Statement
Balance Sheet	Mortgage Application
Cash Flow Statement	Checking Account Statement
Income Statement	Personal Tax Return
Footnotes to Financials	How you explain your finances to an investment advisor or IRS auditor

as –$100,000 (the negative sign indicating that product went out the door). An accounts receivable item indicates that a customer was given credit to pay the bill later, even if the sale has already been made. But cash has not been received and hence, if accounts receivable increases, it means that more bills have not been collected and the cash has been "used."

You might also see cash flow from the issuance of stock of, for example, +$1,000,000, which indicates that stock was issued and was a source of cash (the positive sign showing that cash came into the company).

2: VIEW IT AS A TIME SERIES

You should view the cash flow statement as a time series in a spreadsheet. A time series looks at the cash flow statement on a yearly and a quarterly basis. Here's what you will be looking for:

- *Management Actions*
  Seeing cash flows over time reveals what management is really doing, where the cash is coming from and how management uses the possibly scarce cash resources of a company.
- *Management Strategy*
  You should try to mesh management's use of cash flow with management's growth strategy.

Where do you find the company's strategy?

Most of the time you can find this within the company's 10-K report under the following sections: business overview, management strategy and competition, and management discussion and analysis (MD&A).

This is important because you need to see whether management is putting its money where its mouth is. For example, the airline industry is currently suffering from a decline in corporate travel, shrinking margins, excess capacity and increased competition. In such a case, the airline industry should be (and currently is) looking for cost reductions, such as electronic check-in machines and elimination of some in-flight services. However, some of the suffering airlines are actually spending money on new planes and other equipment.

An example of a conflict: Why is the airline adding more planes when flights have been reduced?

An example of a possible good strategic reason: The airline might be purchasing newer, more fuel-efficient planes to replace older models.

Industry and Economic Trends
These help you understand why the company is implementing its current strategy (or what strategy it should be implementing).

The worst possible scenario is when you see industries consolidate, margins shrink, cash flows from operations decline and a management that is dependent on a high share price and acquisitions to keep growth rates high per expectations and perceptions. Aggressive accounting becomes almost inevitable. This is what happened recently in the telecom equipment sector, with companies such as Lucent Technologies and Nortel Networks. Their strategy of increasing capacity (new hires and manufacturing plants) did not make sense based on the operating cash flows (impacted by industry trends) that were occurring.

As you look at the time series of cash flows, you start to understand how the business really works, and you might even be able to get a sense of what vulnerabilities the company is susceptible to.

3: COMPARE TO OTHER ITEMS

The next step is to compare cash flow with other financial statement line items. This separates how the company says it grew and how it actually grew, via the use of the time series of cash flows.

Let's look at this process using financials from Lucent Technologies (Table 2) as an example.

Compare growth rates in cash flow from operations versus growth rates of revenue and net income.

You will sometimes see companies touting growth in revenue and net income, but you might find that cash flow from operations are in decline. Looking at the line items that impact this tells you the truth about how the company is really doing. Table 2 shows Lucent Technologies' financials from 1997 through 2000.

Reread recent press releases from the company to gauge the difference between what the company touted and what really is going on.

You may notice that what you saw when you first read about a company's newly released financial statements based on corporate press releases is not what you see after you do the calculations.

For example, in October 1999 Lucent Technologies issued a press release covering management's report of revenue and earnings, but not cash flow, headlined "Net income up 50% excluding one-time events; revenues for fiscal 1999 exceed $38 billion. (For the full release, go to http://www.lucent.com/press/1099/991026.coa.html.)

TABLE 2. LUCENT TECHNOLOGIES FINANCIALS (1997 THROUGH 2000)

	1997	1998	1999	2000
		($ millions)		
Revenues	21,483	24,367	30,617	33,813
Net Income	470	1,065	4,789	1,219
Cash Flow From Operations	2,129	1,452	(962)	304
Minus: Capital Expenditures	(1,744)	(1,615)	(2,042)	(2,701)
= Free Cash Flow	385	(163)	(3,004)	(2,397)
Total Debt	4,182	2,861	5,867	6,559
		(%)		
Change in Revenues	—	13.4	25.6	10.4
Change in Net Income	—	126.6	349.7	–74.5
Change in Cash Flow From Operations	—	–31.8	–166.3	131.6

Calculate an estimate of free cash flow.

This can be done by taking cash flow from operations and subtracting capital expenditures. I call this "money the company has after it reinvested into maintaining its business and competitiveness within the industry"—essentially what is "free" to invest in "extra" growth potential.

In the Lucent financials in Table 2, you will see free cash flow as an increasingly negative number, as net income and revenue moved higher. Even more so, you will see the level of debt for the company increase when there was not enough cash flow to support such debt levels.

Isn't it strange to see a company that appears to be "making" money, as emphasized in its press releases, but still needs to borrow debt to finance its operations?

Calculate growth rates of free cash flow over time versus growth rates of revenue and net income.

Free cash flow over time can be volatile for smaller companies given choppy reinvestment amounts, but over time it indicates the long-term cash flow health of the company.

Doing these calculations will compel you to ask questions about the results and encourage you to look deeper into the line-items that made the most impact.

One key caveat: Make sure that you compare growth rates year-over-year to eliminate seasonality. Growth rates are highly volatile within the year and between quarters. Example: Comparing second quarter with first quarter doesn't compute. Compare this year's second quarter with last year's second quarter.

4: THE FOOTNOTES

Last but not least, make sure to read the footnotes. Do not read these first because you will not know about the company's business model, usually found in the business overview section of the 10-K report.

Reading the footnotes takes time, but they're the best guide about how the items on the financial statements are being measured and reported. In particular, read the following sections:

- Changes in accounting policy,
- Revenue recognition,
- Debt discussion and any off-balance sheet debt (operating leases and securitization of receivables),
- Stock options,
- Pension accounting,
- Acquisition analysis,
- Acquisition/asset impairments or goodwill write-downs, and
- Segment reporting.

As a general rule: The longer the discussion of a particular footnote, the more this footnote may become the central issue of your analysis.

THE INITIAL STEPS

Cash flow analysis can be a complicated process. However, as an initial four steps, the process outlined here will give you a much better understanding of the true financial position of any company that may be of interest. ❖