

Busi 293 Notes

Chapter 5

Reporting and Interpreting Cash Flows

Given the present economic situation, companies and investors should pay special attention to, and closely analyze, the Statement of Cash Flows. The Statement of Cash Flows assists users in assessing the extent to which operations are generating sufficient cash flow from the business. Has the company been reinvesting adequate cash resources to provide for future expansion of the business? Has the company been supporting business growth through debt or equity? Is the company generating positive cash flow? The answers to these questions will enable analysts and investors to assess the extent, timing and risk associated with future cash flows.

UNDERSTANDING THE BUSINESS

1. While acknowledging the importance of net income, more attention is now being paid to an entity's cash flow.
2. The Statement of Cash Flows provides feedback on a firm's ability to generate cash from the key areas of activity: Operating, Financing and Investing Activities.
3. The Statement of Cash Flows answers the following cash-related questions:
 - Can the company meet its short-term obligations?
 - How is the company managing key areas of working capital?
 - Is the company making adequate investments in new productive capacity?
 - Has the company generated sufficient cash internally or is there reliance on external sources of funding?
 - Is the company changing the proportion of debt and equity in its capital structure?

CLASSIFICATIONS OF CASH FLOWS

1. The Statement of Cash Flows (SCF) analyzes the change in cash from the beginning of the period until the end of the period.
2. For SCF, cash is considered to be cash equivalents - defined as short-term, highly liquid investments (generally less than 3 months) that are readily convertible into cash and present little risk of loss in value upon conversion to cash.

SCF analyzes cash flow from:

Cash flows from Operating Activities

1. The measurement of ***cash flow from operating activities*** can be determined by either the **direct method** (reports the gross receipts and gross payments) or the **indirect method** (starts with net income and eliminates non-cash transaction that impact net income).
2. It is important to recognize that **cash flow from operations** is the same regardless of which method is used. The indirect method is generally the more widely used. See Textbook reference A.

For Busi 293 you will only be responsible for the indirect method. Please work through the examples in the textbook to acquaint yourself with this method.

Cash flows from Investing Activities

1. Measures cash flow from transactions that relate to the purchase and disposal of long-term productive assets and investments in the securities of other companies.
2. Outflows reflect cash expended to acquire the assets and inflows result from cash received from the disposal of long term assets.
3. The difference between these cash inflows and outflows is referred to as ***net cash flow from investing activities***.

Cash flows from Financing Activities

1. Represents the cash inflows and outflows from external sources (owners and creditors) to finance the enterprise and its operations.
2. Outflows reflect cash used to repay creditors or repurchase shares from owners.
3. The difference between these cash inflows and outflows is referred to as ***net cash flow from financing activities***.

Net Increase (Decrease) in Cash

1. Reconciliation of the net change in cash (equivalents) is presented in the following format:

+/- Net cash from operations

+/- Net cash from investing activities

+/- Net cash from financing activities

= Net increase (decrease) in cash and cash equivalents

+/- Net cash and cash equivalents at beginning of the period

= Net cash and cash equivalents at the end of the period

Textbook reference B provides as a good walkthrough of the process of creating the SCF. You will find the use of T accounts very helpful in analyzing the changes in the Statement of Financial Position accounts. In analyzing current accounts you can simply determine the net change while you must analyze the noncurrent accounts completely as they could have sources and uses of cash.

Relationships to the Statement of Financial Position and the Statement of Earnings

1. Preparation of the Statement of Cash Flows requires analysis of the comparative Statement of Financial Position and Statement of Earnings for the period covered by SCF.
2. Accrual based accounting entries need to be examined for their cash components.
3. The focus is on account balance changes on the Statement of Financial Position.
4. General rules for the Statement of Cash Flows include:
 - Transactions that result in an **increase in assets** will always result in a **decrease in cash flow**
 - Transactions that result in a **decrease in assets** will always result in an **increase in cash flow**
 - Transactions that result in an **increase in liabilities** will always result in an **increase in cash flow**
 - Transactions that result in a **decrease in liabilities** will always result in a **decrease in cash flow**

REPORTING AND INTERPRETING CASH FLOWS FROM OPERATING ACTIVITIES

Remember that cash flow from operating activities will differ in presentation between the two methods (direct vs. indirect) but, as noted above, the total cash flow from operations will be the same. Cash flow from both the financing and investing activities will be identical under both methods.

INDIRECT METHOD

1. Since Net Income is computed using the accrual method, net income will include both cash and non-cash items.
2. Steps to complete:
 - Identify the Statement of Financial Position accounts related to earning income.
 - Adjust net income for non-cash transactions (amortization, gains/losses on disposals of long term investments)
 - Adjust net income for changes in current assets and current liabilities (non-cash working capital) that relate to operations. Cash increases when a current asset decreases or a current liability increases. Cash decreases when a current asset increases or a current liability decreases.
 - See Textbook reference C for an excellent summary on cash flows from operations using the indirect method
3. The format for cash flow from operations should appear as follows:
 - Net Income
 - +/- non-cash income/expense items
 - +/- changes in non-cash working capital
 - =cash flow from (to) operating activities

INTERPRETING CASH FLOW FROM OPERATIONS

1. The focus of cash flow from operations is to provide feedback on the entity's ability to generate cash flow from internal sources through operations and management of working capital.
2. The statement should assist users in assessing the company's ability to meeting ongoing funding requirements, pay cash dividends and contribute to long-term funding.
3. Special attention should be noted for entities that report growing earnings and declining cash flow from operations. Determine the reasons - Is it seasonality? Is it reflective of red flags related to asset management etc?

Financial Ratio

The **Quality of Earnings ratio** measures the portion of earnings that was generated in cash. Users prefer to see a high quality of earnings as it means that earnings are indicative of the cash flow generated by operations. Refer to Textbook reference D for a good discussion of why the quality of earnings ratio may be lower than expected.

Calculation

= Cash flows from Operating Activities/ Net Earnings

REPORTING AND INTERPRETING CASH FLOWS FROM INVESTING ACTIVITIES

REPORTING CASH FLOWS FROM INVESTING ACTIVITIES

1. The focus is on analyzing the changes in account balances in the short-term investment and long-term asset sections of the Statement of Financial Position.
2. Transactions that increase the account balances are reflective of cash outflows and reductions of the account balances are reflective of cash inflows.
3. Decreases in cash flows are the result of acquisitions of short-term investments and long-term assets (acquisitions of shares in another company, fixed asset additions, acquisitions of intangibles etc.).
4. Increases in cash flows generally represent the proceeds received on the dispositions of short-term investments and long-term assets.
5. Amortization and gains and losses although directly related to underlying investing activities are part of cash flow from operations due to their inclusion in the determination of net income.

INTERPRETING CASH FLOWS FROM INVESTING ACTIVITIES

Addressing a company's ability to meet future expansion requirements is addressed in the following ratios:

Capital expenditures ratio

$$= \frac{\text{Cash flow from operating activities}}{\text{Cash Paid for Capital Expenditures}}$$

The ratio captures the extent to which the company has funded capital expenditures from internally generated cash flow.

INTERPRETING CASH FLOWS FROM INVESTING ACTIVITIES continued

Free cash flow

= Cash Flows from Operating Activities-Dividends-Capital Expenditures

This ratio assesses how much cash is available after meeting direct shareholder obligations and capital expenditures necessary to maintain existing capacity.

REPORTING AND INTERPRETING CASH FLOWS FROM FINANCING ACTIVITIES

REPORTING CASH FLOWS FROM FINANCING ACTIVITIES

1. The focus is on activities that involve the generation of funding from creditors and investors and the eventual payments to these stakeholders.
2. It includes related current liabilities (notes payable and current portion of long term debt), long term liabilities and shareholder equity accounts.
3. Increases to notes and long term debt and issues of equity increases cash flow
4. Principal repayments, repurchases of equity and **cash dividends** paid reduce cash flow

ADDITIONAL CASH FLOW DISCLOSURES

NON-CASH INVESTING AND FINANCING ACTIVITY

Non-monetary exchanges, although often material in dollar amounts are not “cash” transactions. Transactions of this nature are reflected in supplemental disclosures. An example of such a transaction would include the purchase of an asset for share capital.

SUPPLEMENTAL CASH FLOW INFORMATION

Additional disclosures require reporting of cash paid and received in respect of for interest and dividends and income taxes.