" There nothing wrong with cash.
It gives you time to think."

Robert R. Prechter, Jr. (1949-)

CASH FLOW STATEMENT

This newsletter completes our little trilogy on financial statements. Our last two newsletters reviewed the Income Statement and Balance Sheet. This one will discuss the most obscure of the three: the Cash Flow Statement. This financial statement is typically only briefly looked at, if at all, by most operational managers and can be the most confounding statement to produce and audit by financial people. We will focus this discussion on using the Cash Flow Statement to supplement the operational insights derived from the Income Statement and Balance Sheet.

Next month we'll discuss how to build a functioning forecasting process. This process involves several functional areas of a company and, if poorly managed, not only produces poor forecasts but also creates real dysfunction in a company.

As we did with the two prior newsletters, we refer you to Wikipedia for a brief, general overview. Here is the Wiki link: http://en.wikipedia.org/wiki/Cash_flow_statement.

Ok, we'll be honest: understanding the cash flow statement is important, but it is about as much fun as fixing a leaking toilet. To prevent sleep, we will aggressively look for humor in cash flow, and suggest at least a couple of cups of coffee for you. Despite being boring, understanding and managing operational cash flow is critical to success. Now, find your preferred form of caffeine, and off we go!

THE BASICS

Just like the balance sheet, the cash flow statement has three big buckets. To help support the livelihood of financial folks in the world, they made these buckets different from the buckets in the balance sheet. So, let's talk about the categories of the cash flow statement. The first is cash from operating sources. The second is cash from investing, such as asset sales, loans, and payment sources, and the third is cash from financing.

The shorthand version of calculating these sections of the cash flow statement is to take net income from the Income Statement, then take the difference between the prior and the current period of various assets, liability, and equity lines on the Balance Sheet. Where each of these differences resides on the cash flow statement depends on the transaction

This documents contains opinions concerning business strategies, practices and tactics. Copyright InSite Partners, LLC, 2010.
InSite Partners, LLC is not responsible for any detrimental effects stemming from the use of these ideas or suggestions.

and the accounting rules relative to it. As you can see this is all three financial statements together. The complication in this shorthand approach is that non-cash transactions, like depreciation, need to be excluded and there are always some non-trivial items that accountants will have to sort out, such as currency fluctuations, intercompany transactions, and structured financial transactions like selling operating losses. From our perspective, if companies complicate their lives by using these mind-bending transactions it is a strong negative indicator. Stated differently, if companies are using a lot of financial transactions it should be, at minimum, a cautionary signal.

In general, unless relative currencies are wildly fluctuating (which can happen) or companies are substantially changing their relationship with each other, these exotic transactions usually do not require much attention from non-financial managers.

When all the fancy hand waving related to the income statement (GAAP versus non-GAAP or pro-forma) is done, look at the cash line on the balance sheet. Is cash being generated or spent? And where is it coming from or going to? How long has this pattern been occurring? Does it make sense?

Key Point: The saying is "Cash is King"; the generation and management of cash are still the ultimate tests of company performance.

Let's look at operational considerations to think about when looking at a Cash Flow Statement. We will segment the discussion by the three sections of the Cash Flow Statement.

CASH FROM OPERATIONS

Net Income

Net income is your starting point, with all other changes in balance sheet line items added or subtracted from this starting point. Being profitable is the equivalent of a jump-start on the cash flow statement. Obviously, if the company is unprofitable, the cash flow begins with a negative number, sort of like a typical telecom or airline company.

Key Point: The only way an unprofitable company can generate cash in the long run is shareholder dilution.

Customers Receipts

If Accounts Receivable have grown from the prior period and the current period, it means customers now owe more money to the company. If this is because customers are not paying, this is a bad situation. Here you can investigate this by looking at the ratio of revenue to receivables. It can simply mean that more product or services were sold, which in general is a good thing. But it also means the company is financing their customers until those receivables are collected and become cash. It takes cash to grow receivables.

One of the most ironic gotcha's in business occurs when a company, with its receivables days outstanding longer than its days payable to vendors (this is quite common), that it can be both profitable and growing nicely but running out of cash. In other words, more money

This documents contains opinions concerning business strategies, practices and tactics. Copyright InSite Partners, LLC, 2010.
InSite Partners, LLC is not responsible for any detrimental effects stemming from the use of these ideas or suggestions.

is going out to pay vendors than money is coming in from sales because of the mismatch in receivable days versus payables days. We have seen companies frequently be overly optimistic in their modeling of receivable and payable cycles only to get caught in operational cash flow binds. To be blunt, it reflects pretty poorly on a management team when they are profitable, and growing like a weed, and are suddenly calling their VCs or a bank for quick cash to make payroll. Words that come to mind to describe the management team in this situation include silly, stupid, or the favorite of the VC, incompetent.

Inventories

If inventories are growing from one period to the next, it means cash is being spent and held as parts sitting on a shelf. There is a fine balance that must be achieved between appropriate inventory to meet product demand and growing inventories to levels that tie up cash with no quick return from customers. If inventories are growing and inventory turns are lengthening, then cash is being needlessly tied up as inventory. Incidentally, inventory growth is fairly natural in a company, in that the operations guys (who hates to ship late) views inventory as a security blanket and marketing/sales folk love to have lots of inventory so that they can get those critical, unforecasted, last minute orders.

If this situation persists past reasonable sales forecast times, excess inventory will have to be written off and will result in a charge or hit to the income statement. Now, not only has the cash not been used to make money, but the charge is hurting company profits. From an operational perspective, growth in inventory levels should be always be evaluated relative to the aging of the inventory. Standing on the outside of a company it is difficult to see the aging of parts. A reasonable top-level proxy for this would be to look at a company's income statement and balance sheet and calculate inventory turns and to look at a company's 10Q and 10K and look for inventory write-off amounts. If either of these two indicators is growing, the company is doing a poor job of managing forecasts and inventory.

Accounts Payable, Compensation Payable, Short-term Liabilities

The difference between the prior and current period balances for these items is usually considered an operating source or use of cash. If these items are increasing from period to period, the company is being financed by its vendors or creditors. While many companies will stretch vendor payments a bit here and there, this is a short-term cash management strategy and not a long-term cash generation method. Incidentally, some contract manufacturers have developed the practice of stretching vendors into an art form.

CASH FROM INVESTING ACTIVITIES

Fixed Assets

The sale or purchase of property, plant, and equipment, including sites, factories, and the like, is shown under the Investing section of a Cash Flow Statement. Also included in this section of the Cash Flow Statement are changes to any loans to suppliers or customers. This is also where payments for merger and acquisitions are shown. In general normal equipment sales and purchases are included in this section. Your eyebrows may be raised if there are large equipment purchases, which may indicate a rise in fixed costs for

This documents contains opinions concerning business strategies, practices and tactics. Copyright InSite Partners, LLC, 2010.
InSite Partners, LLC is not responsible for any detrimental effects stemming from the use of these ideas or suggestions.

manufacturing businesses. In some sectors, the loans to vendors or customers are also warning signs. Tracking the value chain in sectors where this is common can provide interesting insights into the health of the sector. Vendor loans may indicate that margins within the value chain are collapsing. Customer loans may indicate that the underlying value proposition of the product is weak.

CASH FROM FINANCING

Short or Long Term Debt

Balance Sheet changes for debt are shown in the Financing section of the Cash Flow Statement. This is a good place to monitor how well a company is paying off its debt or if it is accumulating more debt.

Selling a Piece of the Company

Most of the changes in the equity section of the Balance Sheet are recorded under the Financing section of the Cash Flow Statement. These include any funds from investors, or any repurchase of shares. In general, any transaction that alters the share count of the company impacts the Financing section of the Cash Flow Statement. These transactions should be very sporadic in nature. If this is the only section of the cash flow statement where funds are consistently being generated, watch out! The most obvious conclusion to draw from this is that the company is continuously losing money and is financing itself by selling shares, much to the detriment of prior shareholders. Stated differently, a company must have a valid path to sustained profitable growth for raising capital through financing in order to be viewed positively.

CONCLUSIONS

Cash management is actually the culmination of the results of several processes that have to be continuously monitored in a company. A Cash Flow Statement, in combination with other financial metrics derived from both the Balance Sheet and the Income Statement, can provide someone outside the company with some idea of how well the management team is generating and using cash or in other words, running the company. In order to have good metrics, the management team has to have good processes in place that are keeping cash flows under control. Some of these processes are basic to the company and impact all functional areas of the company, such as inventory control, handling cash collection from customers, coordinating vendor payment cycles, and, of course, expense control. Without all of these processes working together one or more performance metrics will deteriorate and cash will subsequently leak out of the company. A Cash Flow Statement provides the clues to determine if and where the cash leaks are occurring.

Cheers,

The InSite Team

www.insitepartners.com

This documents contains opinions concerning business strategies, practices and tactics. Copyright InSite Partners, LLC, 2010.
InSite Partners, LLC is not responsible for any detrimental effects stemming from the use of these ideas or suggestions.