

# The Essentials Of Cash Flow

If a company reports earnings of \$1 billion, does this mean it has this amount of cash in the bank? Not necessarily. Financial statements are based on *accrual accounting*, which takes into account non-cash items. It does this in an effort to best reflect the financial health of a company. However, accrual accounting may create *accounting noise*, which sometimes needs to be tuned out so that it's clear how much actual cash a company is generating. *The statement of cash flow provides this information. In this article, we look at what cash flow is and how to read the cash flow statement.*

## What Is Cash Flow?

Business is all about trade, the exchange of value between two or more parties, and cash is the asset needed for participation in the economic system. For this reason - while some industries are more cash intensive than others - no business can survive in the long run without generating *positive cash flow per share* for its shareholders. *To have a positive cash flow, the company's long-term cash inflows need to exceed its long-term cash outflows.*

An outflow of cash occurs when a company transfers funds to another party (either physically or electronically). Such a transfer could be made to pay for employees, suppliers and creditors, or to purchase long-term assets and investments, or even pay for consultants, legal expenses or lawsuit settlements. *It is important to note that legal transfers of value through debt - a purchase made on credit - is not recorded as a cash outflow until the money actually leaves the company's hands.*

A cash inflow is of course the exact opposite; it is any transfer of money that comes into the company's possession. Typically, the majority of a company's cash inflows are from customers, lenders (such as banks or bondholders) and investors who purchase company equity from the company. Occasionally cash flows come from sources like legal settlements or the sale of company real estate or equipment.

## Cash Flow vs Income

It is important to note the distinction between being profitable and having positive cash flow transactions: just because a company is bringing in cash does not mean it is making a profit (and vice versa).

For example, say a manufacturing company is experiencing low product demand and therefore decides to sell off half its factory equipment at liquidation prices. It will receive cash from the buyer for the used equipment, but the manufacturing company is definitely losing money on the sale: it would prefer to use the equipment to manufacture products and earn an operating profit. But since it cannot, the next best option is to sell off the equipment at prices much lower than the company paid for it. In the year that it sold the

equipment, the company would end up with a strong positive cash flow, but its current and future earnings potential would be fairly bleak. Because cash flow can be positive while profitability is negative, investors should analyze income statements as well as cash flow statements, not just one or the other.

### What Is the Cash Flow Statement?

There are three important parts of a company's financial statements: *the balance sheet*, *the income statement* and the *cash flow statement*. The *balance sheet* gives a one-time snapshot of a company's assets and liabilities. And the *income statement* indicates the business's profitability during a certain period.

**The cash flow statement differs from these other financial statements because it acts as a kind of corporate checkbook that reconciles the other two statements.** Simply put, the cash flow statement records the company's cash transactions (the inflows and outflows) during the given period. ***It shows whether all those lovely revenues booked on the income statement have actually been collected. At the same time, however, remember that the cash flow does not necessarily show all the company's expenses: not all expenses the company accrues have to be paid right away. So even though the company may have incurred liabilities it must eventually pay, expenses are not recorded as a cash outflow until they are paid.***

The following is a list of the various areas of the cash flow statement and what they mean:

- **Cash flow from operating activities** - This section measures the cash used or provided by a company's normal operations. It shows the company's ability to generate consistently positive cash flow from operations. Think of "normal operations" as the core business of the company. For example, Microsoft's normal operating activity is selling software.
- **Cash flows from investing activities** - This area lists all the cash used or provided by the purchase and sale of income-producing assets. If Microsoft, again our example, bought or sold companies for a profit or loss, the resulting figures would be included in this section of the cash flow statement.
- **Cash flows from financing activities** - This section measures the flow of cash between a firm and its owners and creditors. Negative numbers can mean the company is servicing debt but can also mean the company is making dividend payments and stock repurchases, which investors might be glad to see.

When you look at a cash flow statement, the first thing you should look at is the bottom line item that says something like "net increase/decrease in cash and cash equivalents", since this line reports the overall change in the company's cash and its equivalents (the assets that can be immediately converted into cash) over the last period. If you check under current assets on the balance sheet, you will find ***cash and cash equivalents (CCE or CC&E)***. **If you take the difference between the current CCE and last year's or last**

**quarter's, you'll get this same number found at the bottom of the statement of cash flows.**

In the example below, Microsoft annual cash flow statement (from June 2004), we can see that the company ended up with about \$9.5 billion more cash at the end of its 2003/04 fiscal year than it had at the beginning of that fiscal year (see "Net Change in Cash and Equivalents"). Digging a little deeper, we see that the company had a negative cash outflow of \$2.7 billion from investment activities during the year (see "Net Cash from Investing Activities"); this is likely from the purchase of long-term investments, which have the potential to generate a profit in the future. Generally, a negative cash flow from investing activities are difficult to judge as either good or bad - these cash outflows are investments in future operations of the company (or another company); the outcome plays out over the long term.

<b>MICROSOFT CORP MSFT</b>				
<b>Annual Cash Flow Statement</b>				
Fiscal year-end for Microsoft Corp falls in the month of June. All items in millions except per-share data.				
	06/30/04	06/30/03	06/30/02	06/30/01
<b>Cash Flow From Operations, Investments &amp; Financial Activities</b>				
Net Income (Loss)	8,168	9,993	7,829	7,34
Depreciation/Amortization & Depletion	1,186	1,439	1,084	1,53
Net Change from Assets/Liabilities	0	1,046	-231	
Net Cash from Discontinued Operations	0	0	0	37
Other Operating Activities	5,272	3,319	5,827	4,16
<b>Net Cash From Operating Activities</b>	<b>14,626</b>	<b>15,797</b>	<b>14,509</b>	<b>13,42</b>
Property & Equipment	-1,109	-891	-770	-1,10
Acquisition/ Disposition of Subsidiaries	-4	-1,063	0	
Investments	-1,632	-5,259	-10,075	-7,63
Other Investing Activities	0	0	0	
<b>Net Cash from Investing Activities</b>	<b>-2,745</b>	<b>-7,213</b>	<b>-10,845</b>	<b>-8,73</b>
<b>Uses of Funds</b>				
Issuance (Repurchase) of Capital Stock	-635	-4,366	-4,572	-5,82
Issuance (Repayment) of Debt	0	0	0	
Increase (Decrease) Short-Term Debt	0	0	0	
Payment of Dividends & Other Distributions	-1,729	-857	0	
Other Financing Activities	0	0	0	23
<b>Net Cash from Financing Activities</b>	<b>-2,364</b>	<b>-5,223</b>	<b>-4,572</b>	<b>-5,58</b>
Effect of Exchange Rate Changes	27	61	2	-2
<b>Net Change In Cash &amp; Equivalents</b>	<b>9,544</b>	<b>3,422</b>	<b>-906</b>	<b>-92</b>
Cash at Beginning of Period	6,438	3,016	3,922	4,84
Cash at End of Period	15,982	6,438	3,016	3,92

The "Net Cash from Operating Activities" reveals that Microsoft generated \$14.6 billion in positive cash flow from its usual business operations - a good sign. Notice the company has had similar levels of positive operating cash flow for several years. If this

number were to increase or decrease significantly in the upcoming year, it would be a signal of some underlying change in the company's ability to generate cash.

### **Digging Deeper into Cash Flow**

All companies provide cash flow statements as part of their financial statements, but cash flow (net change in cash and equivalents) can also be calculated as **net income plus depreciation and other non-cash items.**

**Generally, a company's principal industry of operation determines what is considered proper cash flow levels for the company; comparing a company's cash flow against its industry peers is a good way to gauge the health of its cash flow situation. A company not generating the same amount of cash as competitors is bound to lose out when times get rough.**

**Even a company that is shown to be profitable according to accounting standards can go under if there isn't enough cash on hand to pay bills.** Comparing amount of cash generated to outstanding debt, known as the **operating cash flow ratio**, illustrates the company's ability to service its loans and interest payments. ***If a slight drop in a company's quarterly cash flow would jeopardize its loan payments, that company carries more risk than a company with stronger cash flow levels.***

**Unlike reported earnings, cash flow allows little room for manipulation.** Every company filing reports with the Securities and Exchange Commission (SEC) is required to include a cash flow statement with its quarterly and annual reports. **Unless tainted by outright fraud, this statement tells the whole story of cash flow: either the company has cash or it doesn't.**

### **What Cash Flow Doesn't Tell Us**

Cash is one of the major lubricants of business activity, but there are certain things that cash flow doesn't shed light on. ***For example, as we explained above, it doesn't tell us the profit earned or lost during a particular period: profitability is composed also of things that are not cash based. This is true even for numbers on the cash flow statement like "cash increase from sales minus expenses", which may sound like they are indication of profit but are not.***

As it doesn't tell the whole profitability story, cash flow doesn't do a very good job of indicating the overall financial well-being of the company. Sure, the statement of cash flow indicates what the company is doing with its cash and where cash is being generated, but these do not reflect the company's entire financial condition. The cash flow statement does not account for liabilities and assets, which are recorded on the balance sheet. Furthermore **accounts receivable** and **accounts payable**, each of which can be very large for a company, are also not reflected in the cash flow statement.

In other words, the cash flow statement is a compressed version of the company's checkbook that includes a few other items that affect cash, like the financing section, which shows how much the company spent or collected from the repurchase or sale of stock, the amount of issuance or retirement of debt and the amount the company paid out in dividends.

## Conclusion

*Like so much in the world of finance, the cash flow statement is not straightforward. You must understand the extent to which a company relies on the capital markets and the extent to which it relies on the cash it has itself generated. No matter how profitable a company may be, if it doesn't have the cash to pay its bills, it will be in serious trouble.*

*At the same time, while investing in a company that shows positive cash flow is desirable, there are also opportunities in companies that aren't yet cash-flow positive. The cash flow statement is simply a piece of the puzzle. So, analyzing it together with the other statements can give you a more overall look at a company's financial health. Remain diligent in your analysis of a company's cash flow statement and you will be well on your way to removing the risk that your business will fall victim to a cash flow crunch.*