

# Cash Flow Understanding Statements

## Cash is King

Cash is king. Cash is the life blood of the business. These are statements we hear often. The question is why does a company's profit or even its bank account balance NOT tell us the full picture? In other words, how do we assess a company based on its cash flow statement?

## Why profit is different from cash flow

Businesses adopt a universal accounting principle called Accrual accounting. What this means is that a business transaction is recorded or "accrued" on the basis that a commercial activity has transpired. So for example, when a company shipped products to its customers, it is entitled under this accounting rule to book the revenue, and hence the profit from the sale. It is not important that the cash has not yet been received. This results in an accounts receivable being recognized at the same time. In other words, the business has recorded revenue, which is represented by an amount owing by its customer, which is receivable say, 30 days from the invoice date.

From this simple example, it is possible to see that while the company has recognized a sale and hence its profit, it is still a paper profit without any cash receipt from the customer yet. But just as we cannot eat our paycheck (we need to cash it to buy anything at all), a company cannot "eat" its profit and loss statement. The sale needs to be realized into a cash payment from the customer, 30 days hence.

In the mean time, the company is expected to pay for rental expenses, staff salaries and its suppliers with cash. If the company does not have sufficient cash to make these payments when they are due, they would be in a lot of trouble. Hence we need to also know the cash flow situation of a company, and not just its profit.

## Why the bank balance does not tell us everything

The bank balance tells us how much cash the company actually has on hand at any one point in time. What it does not do is tell us where the cash is coming from. Did it come from the core business operations? Did it come from the company divesting property, plant and equipment or investments? Did it come from bank borrowings or from selling shares? All these have different implications, which a single bank balance does not tell us. This is why we need to get these answers from the cash flow statement.

## What is a cash flow statement?

The cash flow statement essentially tells you the story of how the company ends up with the bank balance it has at the end of the year. For example, if a company starts off with USD10m in bank balance at the start of the financial year, and ends with USD15m twelve months later, the net increase in cash is USD5m. The cash flow statement tells you how did the USD5m came about. It does so by using the three key streams of cash flows: Cash flow from Operating activities, Cash flow from Investing activities and Cash flow from Financing activities.

A simple illustration may help you to visualize easier:

### Direct Method Cash Flow Statement (USD'000)

#### Cash flows from operating activities

Cash receipts from customers	30,150
Cash paid to suppliers and employees	(27,600)
Cash generated from operations	2,550
Interest paid	(270)
Income taxes paid	(900)

#### **Net cash from operating activities**

1,380

#### Cash flows from investing activities

Acquisition of subsidiary X, net of cash acquired	(550)
Purchase of property, plant and equipment	(350)
Proceeds from sale of equipment	20
Interest received	200
Dividends received	200

#### **Net cash used in investing activities**

(480)

#### **Cash flows from financing activities**

Proceeds from issue of share capital	250
Proceeds from long-term borrowings	250
Payment of finance lease liabilities	(90)
Dividends paid	(1,200)

**Net cash used in financing activities** (790)

Net increase in cash and cash equivalents	110
Cash and cash equivalents at beginning of period	120
Cash and cash equivalents at end of period	230

What does this statement tell us? Let's start with the bottom section of the cash flow statement. It says that the company starts off the year with USD120,000 and ends the year with USD230,000 of cash. This is an increase of USD110,000 over the period of one year. How did this increase come about? According to the net cash from operating activities, the company generated USD1,380,000 from its core business. What did it do with the cash it produced? It used USD480,000 in investing activities and USD790,000 in financing activities. The net result is an increase in cash balance by USD110,000.

### **Explanation in plain English**

The company's cash flow is healthy as it is generating the bulk of its cash from its core operating business. This is supplemented by additional fund raising activities from share issue and long-term borrowings. Together, this allows it to expand and reinvest in the business by acquiring a subsidiary and buying more assets and equipment. It also paid out a substantial amount of dividends to its shareholders.

#### **An alternative format**

The above cash flow statement is presented using what is called the Direct Method. You may also come across an alternative presentation format called The Indirect Method. Let's take a look at an example and compare the differences.



**Indirect Method Cash Flow Statement (US'000)****Cash flows from operating activities**

Profit before taxation	3,350
Adjustments for:	
Depreciation	450
Foreign exchange loss	40
Investment income	(500)
Interest expense	400
	<u>3,740</u>

Increase in trade and other receivables	(500)
Decrease in inventories	1,050
Decrease in trade payables	(1,740)
Cash generated from operations	<u>2,550</u>
Interest paid	(270)
Income taxes paid	(900)
	<u>1,380</u>

**Net cash from operating activities 1,380****Cash flows from investing activities**

Acquisition of subsidiary X, net of cash acquired	(550)
Purchase of property, plant and equipment	(350)
Proceeds from sale of equipment	20
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**Cash flows from financing activities**

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**Net cash used in financing activities (790)**

Net increase in cash and cash equivalents 110

Cash and cash equivalents at beginning of period	120
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The main difference is that under the Indirect Method, the starting point is Profit. Why does it do that? The reason is accrual accounting. Recall that under accrual accounting, we know that profit is different from cash. What this statement does is to show us how the company arrived at the final cash balance in the bank account, based on the profit it has generated. In a way, it is a useful bridge for us to make the connection between profit and cash.

Under the accounting standards, both formats of presentation are available to companies, with most adopting the Indirect Method.

**Conclusion**

With a better understanding of the purpose of cash flow statements, this should help supplement your knowledge of a company when assessing its financial health. ■



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**Compare and Contrast**

A visual comparison reveals that the key numbers are all the same. In fact, net cash used in investing activities and net cash used in financing activities are identical in both statements. When you examine net cash from operating activities, this is where you find the difference. While the total of USD1,380,000 is the same, the number is derived differently.

**James Leong Chan Foo** is the founder and master trainer of VisionsOne Consulting, a company which specializes in delivering customized corporate training programs to companies internationally. James' highly popular workshop, "Finance for Non-financial Managers" have been presented to participants from more than 18 countries. He is also an Adjunct Associate Professor with National University of Singapore. James has the honor of being the first invited speaker in Asia to present at InterCall's Asia Pacific webinar series with his topic on "Upsizing your financial intelligence in a financial crisis". James' views on financial analysis and financial planning have also been sought on Media NewsRadio 93.8FM. At the recent Asian Investment Conference, James also spoke on the topic "Interpreting Annual Reports for stock selection". Visit James at [www.visions1.com.sg](http://www.visions1.com.sg) and [www.jamesleonginternational.com](http://www.jamesleonginternational.com).

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