CASH FLOW ESSENTIALS

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CONTENTS

1. INTRODUCTION TO STATEMENTS OF CASH FLOWS

1.1 INTRODUCTION

It is important that you understand the importance of cash flow management.

Whilst an understanding of the financial position of an organisation with respect to its capital and debt levels is important for longer term stability, and profitability is important in the medium to longer term, *no business can exist without sufficient liquidity or cash flow*.

Management of an organisation's cash flow is paramount for short-term management. There have been many examples of businesses which have collapsed through poor management of cash, despite the business model being strong in terms of growth and marketability. The lack of a comprehensive cash flow mechanism by which to identify liquidity problems can be partially blamed for the failure to identify many corporate and other business collapses during the 1980s. Cash flow problems were also attributed to the decline in technology stocks in the late 1990s.

Poor management of cash flow is a common problem for companies experiencing rapid growth rates funded by large amounts of debt, and management of cash flow is critical in the first few years after the formation of any organisation.

1.2 FINANCIAL STATEMENTS: AN ANALOGY

A set of financial statements for an organisation can be likened to the operation of a motor vehicle.

The **Statement of Financial Position** and **Statement of Changes in Equity** represents the individual component parts such as the engine, wheels, body frame, etc. These represent the individual assets and liabilities of the organisation which are necessary for it to be called a 'motor vehicle'. If you don't have the engine (i.e. a vital asset such as plant), then the car will not start (i.e. the organisation can't produce).

The **Statement of Comprehensive Income** represents the degree of fuel efficiency and use of the car. Whilst you can afford to not service the car every now and then, over time this will result in wear and tear and eventual breakdown. This is similar to a loss for an organisation. It can be absorbed for a couple of years, but continuous losses become unsustainable.

The **Statement of Cash Flows** represents petrol and oil. Whilst you may have the best looking car and use it wisely, it isn't going to go anywhere without the necessary fuel and oil. Cash, therefore, is the fuel for any business.

1.3 PURPOSE OF A STATEMENT OF CASH FLOWS

The purpose of a Statement of Cash Flows is to identify and account for the changes in the 'cash' balance from the Statement of Financial Position over a single accounting period. Usually this is for 12 months, although alternate reporting requirements may mandate the production of this information on a six-monthly or quarterly basis, depending on user needs.

Financial statement users need to make decisions about the allocation of scare resources, such as whether to invest capital in a company (shareholder), lend money (creditor), or supply goods to the organisation (supplier). They need to ascertain not only whether an organisation has increased or decreased its cash holdings (which can be gauged from the Statement of Financial Position), but also how much cash came into and out of the business, and from what source.

The Statement of Cash Flows, therefore, provides more detail on the cash position by identifying what activities contributed to overall cash flow. A cash increase or decrease can be a good or bad situation depending on the source of the cash flow and where it is applied.

Cash increase: healthy or unhealthy?

For example, if cash increased due to a positive cash flow from operating activities, then this is a healthy sign given that the source is from the organisation's core business activities, which is an indication of operating efficiency.

However, if cash increases because the organisation is selling off non-current assets, this may be a cause for concern given that non-current assets are often used to generate business activity (such as a machine), and selling off core assets may put the organisation at the mercy of external asset owners. Such an approach may be the result of deeper structural problems within the organisation. However, it may also be perceived as an efficient way of doing business as money is not tied up in low return and idle non-current assets.

Cash decrease: healthy or unhealthy?

In a similar way, a cash decrease can be both a good and bad sign. If cash decreases because non-current assets are being purchased, then this may indicate that the organisation is replacing out-dated production equipment with modern pollution-sensitive equipment, or purchasing land as a long-term investment with the intent of long-term capital gain which reduces rental payments, both of which benefit the organisation in the long term. Furthermore, cash could reduce because a long-term loan is being paid off, which reduces an organisation's debt levels.

However, if cash decreases arise because of negative cash flows from operating activities, that is expenses exceed revenue, then this may signal problems with accounts receivable. The cash flows are, therefore, quite different. In the first case, the payment was incurred for investing and for financing purposes, while in the second case payments were made because of operating deficiencies.

1.4 LIMITATIONS OF STATEMENT OF CASH FLOWS

Whilst cash flow information has been widely accepted as having been used to assess the liquidity/solvency of an organisation, there are a number of limitations with Statement of Cash Flows.

1. *Historical information*. Ultimately a cash flow represents past information. It may be useful for predicting future cash flows, but heavy reliance on the information for any one accounting period can be dangerous. Furthermore, there are numerous macro-economic factors which can affect the firm's cash flow, over which it has no control (e.g. interest rates).
2. *Financial instruments*. A large number of investing and financing activities (e.g. debt-equity swaps and financing of non-current asset purchases by long-term debt), do not affect cash flows in the reporting period. They are reported in the notes.
3. *Timing of transactions*. There are a number of ways in which cash flows can be subject to manipulation by management (e.g. postponing acquisition of large investments, use of finance leasing and delaying cash payments).
4. *Costs*. There are additional costs incurred in collating, categorising and disclosing cash flows. Some accountants argue that these costs outweigh the benefits of providing this information for certain organisations. Some academic research has indicated that cash flow data did not have any significant benefits over accrual based information when predicting bankruptcy (Casey and Bartczak, 1985).
5. *Only the beginning*. The Statement of Cash Flows are only the starting point for analysis of financial statements.

1.5 BENEFITS OF ADOPTING A STATEMENT OF CASH FLOWS

There are five main benefits in adopting a Statement of Cash Flows. It allows an organisation to:

1. Gauge its ability to generate positive future cash flows.
2. Gauge to what degree it needs external funding.

3. Determine whether it can meet its obligations to financiers and shareholders in the form of dividends.
4. Gauge the impact of non-cash investing and financing activities.
5. Analyse the differences between accrual income (operating profit) and cash income (cash flow from operations) through the reconciliation.

TIP

It is important to realise that, despite being profitable, an organisation can go bankrupt because of absence of cash reserves. As indicated above, identifying the reasons for cash inflows and outflows is vital to obtaining an insight into both the operational efficiency and future prospects of an organisation.