Cash Flow Analysis

Meaning:

Cash flow is essentially the movement of cash into and out of a business firm. It is the cycle of cash inflows and cash outflows that determine the firm's solvency. Cash flow analysis is the study of the changes in the financial position of a business enterprise during a given period on the basis of cash. In other words, it studies the changes in the cash position of a business enterprise between two balance-sheet dates. For this purpose, a statement is prepared which is called the funds flow statement. Its main aim is to maintain an adequate cash flow for the business, and to provide the basis for cash flow management.

Cash flow analysis is a method of analyzing the financing, investing, and operating activities of a company. The primary goal of cash flow analysis is to identify, in a timely manner, cash flow problems as well as cash flow opportunities. The primary document used in cash flow analysis is the cash flow statement.

The cash flow statement is useful to managers, lenders, and investors because it translates the earnings reported on the income statement—which are subject to reporting regulations and accounting decisions— into a simple summary of how much cash the company has generated during the period in question.

A typical cash flow statement is divided into three parts: cash from operations (from daily business activities like collecting payments from customers or making payments to suppliers and employees); cash from investment activities (the purchase or sale of assets); and cash from financing activities (the issuing of stock or borrowing of funds). The final total shows the net increase or decrease in cash for the period.

Cash flow statements facilitate decision making by providing a basis for judgments concerning the profitability, financial condition, and financial management of a company. While historical cash flow statements facilitate the systematic evaluation of past cash flows, projected (or pro forma) cash flow statements provide insights regarding future cash flows. Projected cash flow statements are typically developed using historical cash flow data modified for anticipated changes in price, volume, interest rates, and so on.

Purpose / Objectives of Cash Flow Statement:

The balance sheet is a snapshot of a firm's financial resources and obligations at a single point in time, and the income statement summarizes a firm's financial transactions over an interval of time. These two financial statements reflect the accrual basis accounting used by firms to match revenues with the expenses associated with generating those revenues. The cash flow statement includes only inflows and outflows of cash and cash equivalents; it excludes transactions that do not directly affect cash receipts and payments. These non-cash transactions include depreciation or write-offs on bad debts or credit losses to name a few. The cash flow statement is a cash basis report on three types of financial activities: operating activities, investing activities, and financing activities. Non-cash activities are usually reported in footnotes.

The different objectives of cash flow statement are:

1. to provide information on a firm's liquidity and solvency and its ability to change cash flows in future circumstances

2. to provide additional information for evaluating changes in assets, liabilities and equity
3. to improve the comparability of different firms' operating performance by eliminating the effects of different accounting methods
4. to indicate the amount, timing and probability of future cash flows

The cash flow statement has been adopted as a standard financial statement because it eliminates allocations, which might be derived from different accounting methods, such as various timeframes for depreciating fixed assets.

Cash flow activities:

The cash flow statement is partitioned into three segments. They are:

1. Cash flow resulting from operating activities
2. Cash flow resulting from investing activities
3. Cash flow resulting from financing activities.

The money coming into the business is called cash inflow, and money going out from the business is called cash outflow.

i. Operating activities

Operating activities include the production, sales and delivery of the company's product as well as collecting payment from its customers. This could include purchasing raw materials, building inventory, advertising, and shipping the product.

Measuring the cash inflows and outflows caused by core business operations, the operations component of cash flow reflects how much cash is generated from a company's products or services. Generally, changes made in cash, accounts receivable, depreciation, inventory and accounts payable are reflected in cash from operations.

Cash flow is calculated by making certain adjustments to net income by adding or subtracting differences in revenue, expenses and credit transactions (appearing on the balance sheet and income statement) resulting from transactions that occur from one period to the next. These adjustments are made because non-cash items are calculated into net income (income statement) and total assets and liabilities (balance sheet). So, because not all transactions involve actual cash items, many items have to be re-evaluated when calculating cash flow from operations.

For example, depreciation is not really a cash expense; it is an amount that is deducted from the total value of an asset that has previously been accounted for. That is why it is added back into net sales for calculating cash flow. The only time income from an asset is accounted for in CFS calculations is when the asset is sold.

Changes in accounts receivable on the balance sheet from one accounting period to the next must also be reflected in cash flow. If accounts receivable decreases, this implies that more cash has entered the company from customers paying off their credit accounts - the amount by which AR has decreased is then added to net sales. If accounts receivable increase from one accounting period to the next, the amount of the increase must be deducted from net sales because, although the amounts represented in AR are revenue, they are not cash.

An increase in inventory, on the other hand, signals that a company has spent more money to purchase more raw materials. If the inventory was paid with cash, the increase in the value of inventory is deducted from net sales. A decrease in inventory would be added to net sales. If inventory was purchased on credit, an increase in accounts payable would occur on the balance sheet, and the amount of the increase from one year to the other would be added to net sales.

The same logic holds true for taxes payable, salaries payable and prepaid insurance. If something has been paid off, then the difference in the value owed from one year to the next has to be subtracted from net income. If there is an amount that is still owed, then any differences will have to be added to net earnings.

Operating cash flows include:

- Receipts from the sale of goods or services
- Receipts for the sale of loans, debt or equity instruments in a trading portfolio
- Interest received on loans
- Dividends received on equity securities
- Payments to suppliers for goods and services
- Payments to employees or on behalf of employees
- Interest payments (alternatively, this can be reported under financing activities)
- buying Merchandise

Items which are added back to [or subtracted from, as appropriate] the net income figure (which is found on the Income Statement) to arrive at cash flows from operations generally include:

- Depreciation (loss of tangible asset value over time)
- Deferred tax
- Amortization (loss of intangible asset value over time)
- Any gains or losses associated with the sale of a non-current asset, because associated cash flows do not belong in the operating section.(unrealized gains/losses are also added back from the income statement)

ii. Investing activities

Changes in equipment, assets or investments relate to cash from investing. Usually cash changes from investing are a "cash out" item, because cash is used to buy new equipment, buildings or short-term assets such as marketable securities. However, when a company divests of an asset, the transaction is considered "cash in" for calculating cash from investing. Investing activities include:

- Purchase or Sale of an asset (assets can be land, building, equipment, marketable securities, etc.)
- Loans made to suppliers or received from customers
- Payments related to mergers and acquisitions

iii. Financing activities

Financing activities include the inflow of cash from investors such as banks and shareholders, as well as the outflow of cash to shareholders as dividends as the company generates income. Other activities which impact the long-term liabilities and equity of the company are also listed in the financing activities section of the cash flow statement.

Changes in debt, loans or dividends are accounted for in cash from financing. Changes in cash from financing are "cash in" when capital is raised, and they're "cash out" when dividends are paid. Thus, if a company issues a bond to the public, the company receives cash financing; however, when interest is paid to bondholders, the company is reducing its cash.

Financing activities include:

1. Proceeds from issuing short-term or long-term debt
2. Payments of dividends
3. Payments for repurchase of company shares
4. Repayment of debt principal, including capital leases
5. For non-profit organizations, receipts of donor-restricted cash that is limited to long-term purposes

Items under the financing activities section include:

- Dividends paid
- Sale or repurchase of the company's stock
- Net borrowings
- Payment of dividend tax

Uses / Significance / Advantages of Cash Flow Statement:

a. It is especially useful in preparing cash budgets.

b. It helps the newly formed companies to know their inflow and outflow of cash.

c. It helps the investors to judge whether the company is financially sound or not.

d. It helps the company to know whether it will be able to cover the payroll and other expenses.

e. It helps the lenders to know the company's ability to repay.

f. A cash flow statement is provided on monthly basis or quarterly basis or six monthly basis or yearly basis.

g. These statements help to have an accurate analysis of the firm's ability to meet its current liabilities.

h. A cash flow statement is helpful for planning and managing future financial commitments.

i. cash flow statement summarizes the company's cash receipts and cash payments over a period of time.

j. It is useful for determining the short term ability of the concern to meet its liabilities i.e. helps the management in taking short-term financial decisions.

k. A cash flow statement gives vital information not only about the company's performance but also about its major activities during the year

l. Cash Flow statement is also a control device for the management.

m. Since it gives a clear picture of cash inflow from operations (and not income flow of operation), it is, therefore, very useful to internal financial management such as in considering the possibility of retiring long-term debts, in planning replacement of plant facilities or in formulating dividend policies.

n. It enables the management to account for situation when business has earned huge profits yet run without money or when it has suffered a loss and still has plenty of money at the bank.

Disadvantages/Limitations of Cash Flow Statement:

- By itself, it cannot provide a complete analysis of the financial position of the firm.
- It can be interpreted only when it is in confirmation with other financial statements and other analytical tools like ratio analysis.
- It may not give accurate details about the money coming into and going out of the business. Costs may change and this could cause the business to loose money.
- Since it shows only cash position, it is not possible to arrive at actual profit and loss of the company by just looking at this statement alone.
- In isolation this is of no use and it requires other financial statements like balance sheet, profit and loss etc..., and therefore limiting its use
- It is difficult to precisely define the term 'cash'.
- Working capital is a wider concept of funds. Therefore a funds flow statement gives a clearer picture than a cash flow statement.