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Cash flows – Part I:
Understanding the cash flow statement

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Introduction

You may be making a profit – that is a great start. But are you making enough to pay dividends as well as pay off your long term debts? Do you have enough cash to invest in future improvements?

Many people look at their income and balance sheet at least on a monthly basis – but not many spend time looking at their cash flow statement. Often this is because their accounting system does not automatically provide it, or they don't understand what they are looking at.

What it can tell you

It is important you take the time to get familiar with this statement as it can tell you some very useful things:

- How well you turn profits into cash
- How well placed you are to invest in future improvements
- Whether you are running your assets into the ground
- Your ability to generate enough cash to pay dividends and also pay off long-term debt

A cash flow statement is quite logical and easy to read. There are three main components that split the business up into day-to-day operations, infrastructure investments, and financing of the business.

Simplified cash flow statement

Operating cash flows	
Cash received from customers	$100,000
Cash paid to employees and suppliers	($80,000)
Investing cash flows	
Cash paid to buy long term assets	($20,000)
Cash received from the sale of long term assets	$5,000
Financing cash flows	
Borrowings received from lenders	$20,000
Dividends paid to shareholders	($5,000)
Net cash flows	**$20,000**

Day-to-day operations

This section answers some critical questions:

1) Do we sell our products or services for more than they cost?
2) Are we collecting our revenues?
3) How much cash is left over from day-to-day business to pay debts and dividends?

Section 1: Cash flow from operations	Profit & loss equivalent
Cash receipts from customers	Revenue
(Cash payments to suppliers)	(Cost of sales and general expenses)
(Cash payments to employees)	(Wages expenses)
Interest received	Interest income
(Interest paid)	(Interest expenses)
(Taxes paid)	(Tax expenses)
Net cash from operations	**Net profit**

If you do not have positive operating cash flows this indicates the business is facing significant problems.

WARNING

If cash receipts are significantly lower than revenues, you may have poor systems for collecting cash or some serious bad debts (or else someone could be cooking the books).

WARNING WARNING WARNING

If you have good profits but negative cash from operations you have a very big problem – You are declaring profits but they don't really exist.

Compare the results for 2012 for Qantas and Tiger airlines

	Qantas	**Tiger**
	$ millions	**$ millions**
Cash receipts	$16,699	$610
Cash payments	($14,795)	($697)
Interest received	$170	$2
Interest paid	($285)	($9)
Dividends received	$22	-
Income tax	($1)	$0.6
Net cash from operating activities	**$1,810**	**($93)**

Immediately we can see that Tiger is in a difficult position. It is paying out more to employees and suppliers than it is receiving from customers which is not sustainable. Meanwhile Qantas has generated nearly $2 billion in cash.

Long term investments in assets

A business has assets used for day-to-day trading (such as cash, inventory and debtors). These are called current assets in the balance sheet. It also has long term assets that provide infrastructure for the business. These include property, plant, equipment, furniture, computers and vehicles. These are usually called Non-Current Assets in the balance sheet.

The investing section shows what non-current assets such as property, plant, equipment and land have been purchased or sold during the period. This information is not shown in the income statement, but still has an important impact on both our current cash position and our future ability to be competitive.

This section helps us focus on two main items:
1) Are we investing in new assets to replace those that are becoming obsolete?
2) Are we selling off 'infrastructure' to generate cash because we are struggling?

Section 2: Cash flow from investing	**Balance sheet equivalent**
Cash receipts from sale of infrastructure assets	Decrease in NCA balances
(Cash payments for purchase of infrastructure assets)	Increase in NCA balances
Net cash from investing activities	

Compare the results for 2012 for Qantas and Tiger airlines

	Qantas	**Tiger**
	$ millions	**$ millions**
Purchase of property, plant & equipment, and intangible assets	($2,304)	($470)
Proceeds from disposal of property, plant & equipment	$66	$345
Other	($44)	($4)
Net cash from investing activities	**($2,282)**	**($129)**

We can see that both companies have a negative cash result in this section. This may appear a poor result, but actually this is usually a positive outcome. The focus here is on investing in quality assets for future growth and performance. Qantas has purchased over $2 billion of assets, and these will include the super efficient Boeing Dreamliner and A380 Airbus. This will lead to greater revenues and lower costs in the future, making them more competitive.

Financing the business

The third section shows us how the business is financed. How much debt is being borrowed or repaid, as well as any equity injections by owners or dividend payments.

We can investigate:

1) Are we repaying debts when required?
2) Are our dividend levels appropriate?

Section 3: Cash flow from financing	**Balance sheet equivalent**
Cash receipts from borrowings	Loan balances – increasing
Cash receipts from raising equity	Equity (capital) balances increasing
(Cash payments to pay off debts)	Loan balances – decreasing
(Cash dividend payments to shareholders)	Equity (retained profits) balance decreasing
Net cash from financing activities	

Compare the results for 2012 for Qantas and Tiger airlines

	Qantas	**Tiger**
	$ millions	**$ millions**
Proceeds from borrowings	$688	$207
Proceeds from issuing new equity	-	$155
Repayments of borrowings	($566)	($163)
Other	$248	($12)
Net cash from financing activities	**$370**	**$187**

Here we can see that Tiger is raising significant amounts of money to finance its business. It needs to do this because it is losing money in its day-to-day operations and also investing heavily in new assets.

Conclusion

In Part I we have looked at how a cash flow statement is constructed and presented. A monthly review of your cash flow statement, along with your income statement and balance will give you useful insights into how your organisation is performing. In Part II we will look at how we can examine the cash flow statement in more detail to highlight particular problems.

If you would like help creating or analysing your organisation's cash flows please contact courtney@keq.com.au.