Cash flows – Part II:
Analysing the cash flow statement

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Introduction

Here is the Timbercorp Limited Financial Statements for their final year before going bust. By examining these results and contrasting them with the income statement you can get a sense of what is similar and where to look for discrepancies.

In the first instance, the profit results appear to be an incredibly healthy looking set of numbers. Nearly half a billion dollars in revenue and return on sales of nearly 10% with net profit close to $50 million.

Income Statement for financial year ended 30 September 2008	**$ millions**	
$ millions	**2008**	**2007**
Revenue	$494.4	$453.7
Other revenues (expenses) including asset revaluations	-$0.9	$19.6
Project management and operating costs	-$274.6	-$239.2
Employee related expenses	-$24.5	-$27.1
Marketing costs	-$21.5	-$21.6
Corporate and other expenses	-$15.6	-$19.0
Depreciation and amortisation expenses	-$15.5	-$10.6
Borrowing and finance charges	-$82.0	-$63.6
Profit before income tax expense	**$59.8**	**$92.3**
Income tax expense	-$18.1	-$25.9
Profit for the year	**$41.6**	**$66.4**
Loss / (profit) attributable to minority interests	$3.0	-$0.7
Profit attributable to equity holders of the parent	**$44.6**	**$65.7**

Despite the strong figures there are a few interesting issues, with the higher revenues not being matched by an equivalent growth in profit. Profits actually declined $20 million as a result of much higher borrowing and finance charges (increase of $20m) and project management costs ($25m).
There were also $20 million in asset revaluations in 2007 that were not repeated in 2008.

Based on this profitability, many people were still happy to invest. But, I wonder if they would have been so confident if they had examined the cash flow statement as well.

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Analysing Cash Flow Statement: Section 1

Let's start with section 1 of the cash flow statement – the day-to-day operations.

Cash flow statement	**$ millions**	
	2008	**2007**
Cash flows from operating activities		
Receipts from customers	$357.0	$335.0
Payments to suppliers and employees	-$356.1	-$328.1
Dividends / distributions received	$6.6	$6.5
Interest received	$41.4	$33.0
Interest and other borrowing costs paid	-$82.3	-$55.0
Income tax (paid) / refunded	$3.7	-$36.0
Net cash (used in) / provided by operating activities	**-$29.8**	**-$44.7**

Receipts from customer are nearly $150m less than the declared revenues.

Payments to suppliers and employees are virtually the same as cash receipts – and that's before we pay interest or taxes.

Despite declaring a $45 million profit in 2008, Timbercorp actually had a **$30 million cash deficit** from their day-to-day operations.

How can you make a $45 million profit when you lose $30 million in cash??????

2007 also seems to offer up some interesting numbers. With revenues of $454m, Timbercorp made a profit of nearly $66 million – a staggering result. But, somehow they had even less cash from operations than the previous year – a deficit of nearly **$45 million.**

So we ask another question –
How can you make $66 million profit when you lose $45 million in cash?

Let's look at the 3 questions we identified earlier:

1) Do we sell products or services for more than they cost? NO
2) Are we collecting our revenues? NO
3) How much cash is left over from day-to-day business to pay debts and dividends? NONE

It seems pretty obvious that this company requires further investigation before investing any money.

Reading

Extract from the Directors' Report of the Annual Report:

"Operating cash outflows of $29.775 million compare favourably to the $44.725 million outflow recorded in 2007. This is largely due to a significant reduction in income tax payments. The negative operating cash flows principally reflect lower earnings and the continued investment in the grower loan book of $75.655 million and deferred management fee receivables of $34.283 million."

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Note that this doesn't really explain anything. Yes – losing $30m compares favourable to losing $45m but it doesn't compare favourably to making a profit or any other measure of successful performance. To link it to less 'tax' is a bit interesting – of course you pay less tax when you make less profits – but this explains the difference to the $45m not the reason they are $30m in the red.

Further down in the Directors' Report – at the bottom of the second page of very small print we get:

"Bank facilities totalling $235.000 million have been classified as current borrowings in line with the accounting standards, as at the reporting date the Group was considered to be in breach of certain financial covenants. However, subsequent to year end, these covenants were waived by the relevant banks for the reporting period."

Probably something worth discussing in further detail?

NOTE: Further investigation in this area reveals that 2006 showed a similar situation with a **deficit of $13 million cash from operations** despite declaring an $**80 million profit**.

The real question becomes – how long can a company survive with negative operating cash flow?

Answer:
A very short time (unless it gets cash from new investors or sells off its infrastructure assets).

Analysing Cash Flow Statement: Section 2

Next we look at section 2, which shows us infrastructure spending and receipts. We can see that significant payments are being made for non-current assets (over $100 million in each year).

Cash flows from investing activities		
Receipts / Proceeds from sale of NCA and other financial assets	$14.5	$13.0
Payments for non-current assets (PPE, agricultural, intangible)	-$114.8	-$274.2
Net cash used in investing activities	**-$100.3**	**-$261.4**

This may seem counter-intuitive, but it is a good sign to have negative cash flows in this section. This is because it represents investments in the future. However, the key thing is having the cash to pay for these items – and Timbercorp certainly isn't generating that cash from its day-to-day operations. So the question we must ask is:

Where is the cash coming from to (i) stay afloat; and (ii) spend all of this money on infrastructure?

Analysing Cash Flow Statement: Section 3

Let's turn to section 3 of the cash flow statement to answer these questions.

Cash flows from financing activities		
Proceeds (net) from issuing and placing shares	$58.6	$21.0
Proceeds from borrowings	$144.0	$258.7
Repayments of borrowings	-$75.0	-$62.0
Dividends paid	-$10.1	-$15.4
Net cash provided by financing activities	**$117.5**	**$202.4**

People were happy to invest or lend nearly $280m in 2007 and another $200 million in 2008 – to a company that has no positive cash flow. WHY?

How could a company that has such a poor operating cash position stay alive for so long?

Normally it is not possible – you would not be able to pay employees and suppliers, and would end up going bust very rapidly. But, for some reason Timbercorp has been able to convince lenders and investors to pump in over $480 million in a 2 year period, which helped it pay its bills and also invest further.

Why would investors be willing to do this?

Potential answers include:

- Attraction to the 'tax benefits' of this type of investment
- Believing the glossy pictures and the salesman hype of those promoting it
- Only reading the income statement which showed great levels of profitability

Sadly, Timbercorp and its doppelganger Great Southern both collapsed because of their unsustainable business models, leaving investors and lenders with billions of losses. The question is – could we have seen this problem coming and stopped such a catastrophic failure?

Conclusion

In Part II we have analysed a cash flow statement. As you can see – a cash flow statement is a powerful tool for quickly identifying whether you:

a) are **generating** cash from your day-to-day business
b) are **investing** for future success
c) have **enough cash** to pay debts and dividends.

I hope your cash flow statement paints a slightly better picture, and that you don't get sucked into poor quality investments that don't generate any cash. In Part III, we will start to look at cash ratios which will help paint an even better picture of your cash position and performance over time.

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