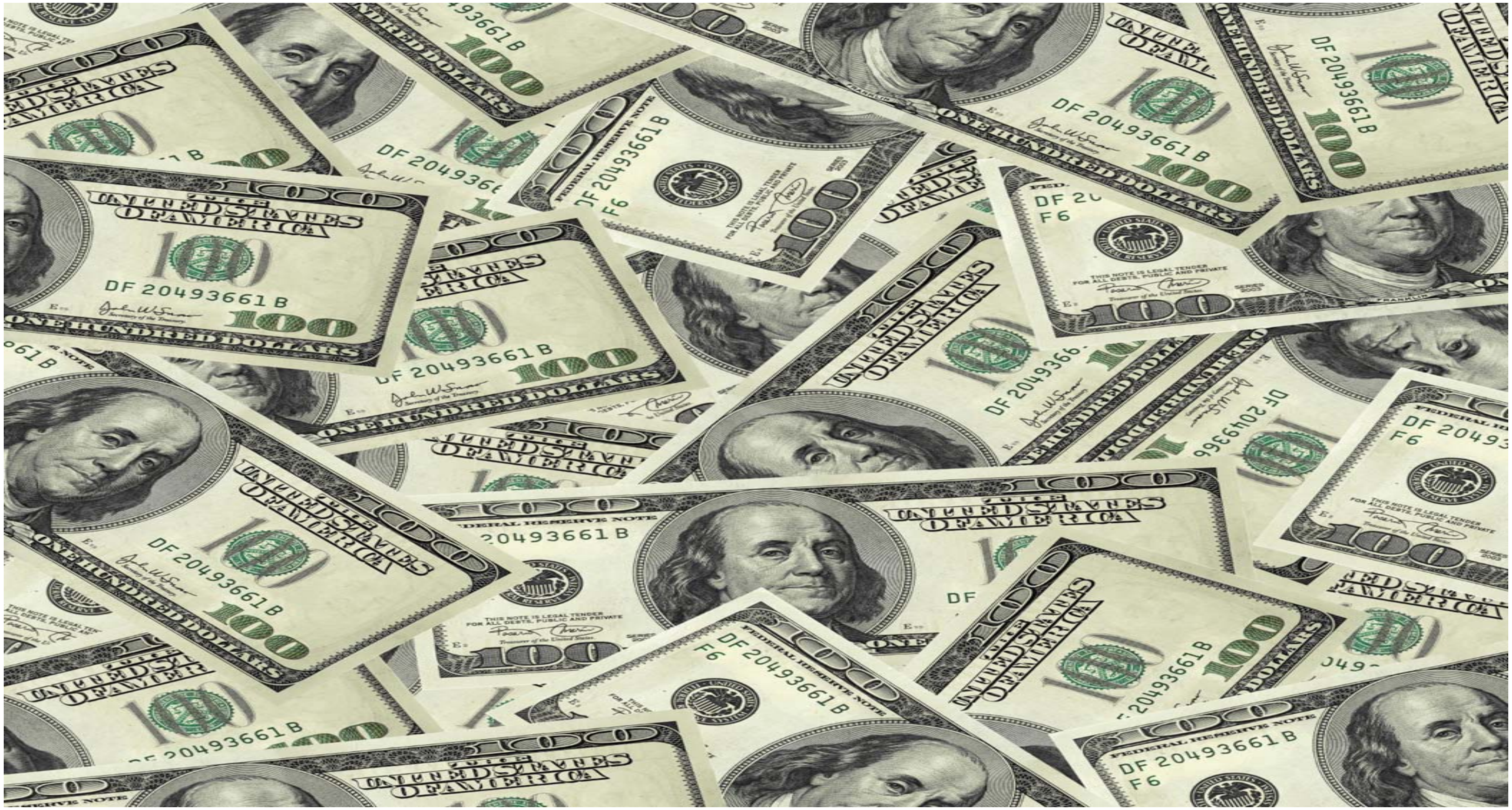
IMPORTANCE OF GENERATING CASH

presentation by Ronald A. Sereika, CCE, CEW



PROBLEM IS CASH

Consider the following scenarios:

- You are a banker evaluating a loan request from a prospective customer. What is your primary concern when making a decision regarding approval or denial of the loan request?
- You are a wholesaler of goods and have been asked to sell your products on credit to a potential buyer. What is the major determining factor regarding approval or denial of the credit sales?
- You are an investor in a firm and rely on receipt of regular cash dividends as part of your return on investment. What must the firm generate in order to pay you your dividends?

THE ANSWER IS CASH

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

- Firm needs cash to satisfy creditors and investors
- Shortfalls of cash can be satisfied by borrowing or other means, such as, selling long-lived assets

SUCCESS = CASH

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

- **HIGH interest rates and inflation**: Investors and creditors focus on cash flows
  - INTEREST RATES HIGH: the cost of borrowing to cover short term cash can be out of reach for many firms looking to cover temporary cash shortages
  - INFLATION: may distort the meaningfulness of net income through the understatement of depreciation and cost of goods sold expenses making other measures of operating performance and financial success important.
- **LOW interest rates and inflation**: there are other factors which limit the usefulness of net income as a barometer of financial health.

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

No-Cash Corporation
Income Statement for year 1 and 2.

FINANCIALS	YEAR 1	YEAR 2
NET SALES	50,000	100,000
NET EXPENSE	40,000	70,000
INCOME	10,000	30,000

PROFIT TRIPLED Y/Y

PROBLEM IS CASH

A firm can be **HIGHLY PROFITABLE <u>AND</u>**

- ☑ not be able to pay dividends or invest in new equipment
- ☑ not be able to service debt
- ☑ GO BANKRUPT

HOW?

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

FACTORS TO CONSIDER

(do not appear on income statement)

1. In order to improve sales in Year 2, No-Cash eased its credit policies and attracted customers of substantially lower quality than in Year 1
2. No-Cash purchased a new line of inventory near the end of Year 1 and it became apparent during Year 2 that the inventory could not be sold except at substantial reductions below cost.
3. Rumors regarding No-Cash's problems with regard to accounts receivable and inventory management prompted some suppliers to refuse the sale of goods on credit to No-Cash.

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

No-Cash Corporation
Balance Sheet at December 31, Year 2.

FINANCIALS	YEAR 1	YEAR 2	CHANGE
Cash	$2,000	$2,000	0
Accounts Receivables	$10,000	$30,000	+$20,000 (1)
Inventories	$10,000	$25,000	+15,000 (2)
Total Assets	$22,000	$57,000	+35,000
Accounts Payable	$7,000	$2,000	-5,000 (3)
Notes Payable to Banks	0	$10,000	+$10,000
Equity	$15,000	$45,000	$30,000
Total Liabilities and Equity	$22,000	$57,000	$35,000

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

No-Cash Corporation
Indirect Method of Determining Cash Flow - Year 2

FINANCIALS	YEAR 2
Net Income	$30,000
(Subtract) increase of A/R	($20,000)
(Subtract) Increase in Inventory	($15,000)
(Subtract) Decrease in A/P	($ 5,000)
Cash Generated	($10,000)

Would you lend this firm $10,000?

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

Reminder of the Impact
Balance Sheet Items on Cash

INFLOWS	OUTFLOWS
Decrease in an asset account	Increase in an asset account
Increase in a liability account	Decrease in a liability account
Increase in a equity account	Decrease in an equity account

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

Where does the inflow or outflow of a transaction go on the statement of cash flows?

Any transaction that involves cash will fall in one of the following three sections:

- **Cash flow from Operations**
- **Cash flow from Investing**
- **Cash flow from Financing**
- **We will need to place each cash transaction and put it in one of the above sections. Remember, the total of the cash inflows less the outflows balance to the net change in the cash account from one year to the next.**
- **This is always the total of the cash account and the marketable securities account at their fiscal year end compared to their next year end.**

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

Where does the inflow or outflow of a transaction go on the statement of cash flows?

1. **Preparing the statement of cash flows will begin with looking at the balance sheet.**

- **Remember, the balance sheet shows us the balances of accounts at one date in time, so we need to compare that date (normally a year end) with the following year.**
- **The statement is called a statement of flows because it shows changes over time rather than the absolute dollar amount of the accounts at a point in time.**

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

To Review: Lets break the balance sheet down into the four areas that make up a cash flow statement:

- ✓ Cash
- ✓ Operating Activities
- ✓ Investing Activities
- ✓ Financing Activities

FIRM’S FINANCIAL HEALTH DETERMINED BY CASH FLOW

- ✓ **CASH** – includes cash and highly liquid short-term marketable securities also known as cash equivalents. These include U.S. treasury bills, bonds, certificates of deposit and notes.
- ✓ **OPERATING ACTIVITIES** – includes delivering or producing goods for sale and providing services, where the cash effects of transactions enter into the determination of income.

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

- ✓ **OPERATING ACTIVITIES – includes delivering or producing goods for sale and providing services, where the cash effects of transactions enter into the determination of income.**

INFLOWS	OUTFLOWS
Sale of goods	Payment for purchases of inventory
Revenue from Services	Payment for purchases from suppliers other than inventory
Returns on interest earning assets (interest)	Payments to lenders (INTEREST)
Return on equity securities (dividends)	Payment for taxes
	Payments for operating expenses (salaries, rent, insurance.)

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

✓ **INVESTING ACTIVITES** - **includes the acquiring and selling or otherwise disposing of securities that are not cash equivalents and productive assets that are expected to benefit the firm for long periods of time. Also includes lending money and collecting on loans.**

INFLOWS	OUTFLOWS
Sales of long- lived assets such as PPE	Acquisition of long-lived assets
Sales of debt or equity securities of other entities (except trading securities)	Purchases of debt or equity securities of other entities (except trading securities)
Returns from loans (Principle) to others	Loans (Principle) to others

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

- ✓ **FINANCING ACTIVITIES – include borrowing from creditors and repaying the principal and obtaining resources from owners and providing them with a return on the investment.**

INFLOWS	OUTFLOWS
Proceeds from borrowing	Repayment of debt principal
Proceeds from issuing the firm's own securities	Repurchase of a firms own shares (Treasury)
	Payment of dividends

FIRM'S FINANCIAL HEALTH DETERMINED BY CASH FLOW

The other method of calculating cash flow is the DIRECT METHOD which:

- **Illustrates the calculation of net cash flow from Operating activities only.**
  - **This method translates each item on the accrual based income statement to a cash revenue or expense item.**
  - **The direct method shows cash collections from customers, interest and dividends collected, other operating cash receipts, cash paid to suppliers and employees, interest paid, taxes paid, and other operating cash payments.**
- **The direct and indirect methods yield identical figures for net cash flow from operating activities because the underlying accounting concepts are the same. According to Accounting Trends and Techniques, 593 out of 600 firms used the indirect method in 2003.**

Worksheet for Preparing Statement of Cash Flows

	1999	1998	CHANGE IN 1999-1998	CATEGORY
ASSETS				
CASH	$ 4,061	$ 2,382	$ 1,679	CASH
MARKET SECURITIES	$ 5,272	$ 8,004	($ 2,732)	CASH
ACCOUNTS REC	$ 8,960	$ 8,350	$ 610	OPERATING
INVENTORIES	$47,042	$36,769	$10,272	OPERATING
PREPAID EXPENSES	$ 512	$ 759	($ 247)	OPERATING
PROP PLANT EQUIP	$40,607	$26,507	$14,100	INVESTING
ACCUMULATED DEP	(11,528)	($7,530)	($ 3,998)	OPERATING
OTHER ASSETS	$ 373	$ 668	($ 295)	INVESTING
LIABILITIES & STOCKHOLDERS EQUITY				
ACCOUNTS PAYABLE	$14,294	$ 7,591	$ 6,703	OPERATING
NOTES PAYABLE - BANKS	$ 5,614	$ 6,012	($ 398)	FINANCING
CURRENT MATURITIES LTD	$ 1,884	$ 1,516	$ 368	FINANCING
ACCRUED LIABILITIES	$ 5,669	$ 5,313	$ 356	OPERATING
DEFERRED INCOME TAXES	$ 843	$ 635	$ 208	OPERATING
* LONG TERM BORROW	$21,059	$16,975	$ 4,084	FINANCING

Using the Indirect Method for Cash Flows

Cash Flows from Operating Activities	
Net Income	$9,394
Non Cash Operating Items	
+Depreciation	$3,998
+Increase in Deferred Tax Liability	$208
Cash provided (used) by current asset, liabilities.	
-Increase in accounts received	($610)
-Increase in Inventory	($10,272)
+Decrease in prepaid expenses	$247
+Increase in Accounts Payable	$6,703
+Increase in Accrued Liabilities	$356
Net Cash Flow from Operating Activities	$10,024
Cash Flows from Investing Activities	
Additions to Property, Plant & Equip	($14,100)
Other Investing Activities	$295
Net Cash provided (used) by investing activities	($13, 805)
Cash Flow from Financing Activities	
Sale of Common Stock	$ 256
Increase (Decrease) in Short Term Borrow.	($ 30)
(Including Current Maturities of long term debt)	
Additions to long terms borrowing	$ 5,600
Reductions to long term borrowing	($ 1,516)
Dividends Paid	($ 1,582)
Net Cash provided (used) by financing activities	$ 2,728
Increase (Decrease) in Cash and Marketable Securities	**($ 1,053)**

Worksheet for Preparing Statement of Cash Flows

	1998	1999	CHANGE IN 1998-1999	CATEGORY
STOCKHOLDERS EQUITY				
COMMON STOCK	$ 4,803	$ 4,594	$ 209	FINANCING
ADDITIONAL PAID IN	$ 957	$ 910	$ 47	FINANCING
RETAINED EARNINGS	$40,175	$32,363	$7,812	**
* ADDITIONS TO LONG TERM BORROWINGS			$ 5,600	FINANCING
REDUCTIONS OF LONG TERM BORROWINGS			($ 1,516)	FINANCING
NET CHANGE IN LONG TERM DEBT			$ 4, 084	
** NET INCOME (OPERATING)			$ 9,394	OPERATING
DIVIDENDS PAID			($ 1,582)	FINANCING
CHANGES IN RETAINED EARNINGS			$ 7,812	