

Cash Flow

How much money do I need?

By reviewing the statement of cash flows and considering these steps and questions, you can gain a crucial understanding of a company's liquidity, financial flexibility, and overall **financial health**. Analyzing it in conjunction with the income statement and balance sheet provides a comprehensive view of the company's financial performance and position.



Key questions to answer

- * Is the company generating sufficient cash from its core operations?
- * Is the company making necessary investments in its future?
- * How is the company financing its growth and operations?
- * Is the company's free cash flow positive and growing?
- * Is the company managing its debt effectively?
- * Are there any significant non-cash transactions

that should be considered?

Step-by-Step Guide to Reviewing the Statement of Cash Flows

The statement of cash flows (SCF) tracks the movement of cash and cash equivalents both into and out of a company over a period of time. It's crucial because while the income statement shows profitability, the SCF reveals the company's ability to generate cash, which is essential for meeting its short-term obligations and funding future growth.

The SCF is typically divided into three sections:

Operating Activities: Cash flows generated from the company's core business operations (e.g., cash received from customers, cash paid to suppliers and employees).

Investing Activities: Cash flows related to the purchase and sale of long-term assets (e.g., property, plant, and equipment; investments in other companies).

Financing Activities: Cash flows related to how the company is funded (e.g., borrowing and repaying debt, issuing and repurchasing stock, paying dividends).

Here's how to approach reviewing a statement of cash flows:

Step 1: Understand the Basic Structure and Sections

Identify the Three Sections: Make sure you can clearly distinguish between the cash flows from operating, investing, and financing activities.

Note the Reporting Period: Pay attention to the time period the statement covers, as with the income statement.

Step 2: Analyze Cash Flow from Operating Activities

* **Focus on the Starting Point:** Understand whether the company uses the direct or indirect method to present cash flow from operations.

Direct Method: Reports the actual cash inflows and outflows from operating activities.

Indirect Method: Starts with net income and adjusts it for non-cash items and changes in working capital accounts (like accounts receivable, inventory, and accounts payable) to arrive at cash flow from operations. The indirect method is more common.

*** Assess the Quality of Earnings:** Ideally, a company should generate positive cash flow from its core operations. Compare net income to cash flow from operations. Significant differences might indicate non-cash accounting items are having a large impact on reported earnings.

Review Key Adjustments (Indirect Method): If the indirect method is used, pay attention to significant adjustments to net income:

Depreciation and Amortization: These are non-cash expenses added back to net income.

Changes in Working Capital: Analyze changes in current assets and current liabilities. For example, an increase in accounts receivable (meaning customers are taking longer to pay) will decrease cash flow, while an increase in accounts payable (meaning the company is taking longer to pay its suppliers) will increase cash flow.

Look for Trends: Analyze cash flow from operations over several periods. Is it consistently positive and growing?

Step 3: Analyze Cash Flow from Investing Activities

*** Focus on Capital Expenditures (CAPEX):** Significant cash outflows for the purchase of PP&E are common as companies invest in their future. Understand the nature and necessity of these investments.

*** Review Acquisitions and Disposals:** Note any cash flows related to the purchase or sale of other companies or long-term assets.

*** Analyze Investments:** Look at cash flows related to the purchase or sale of investment securities.

*** Understand the Overall Trend:** Is the company consistently investing in its business? Significant negative cash flow from investing activities is typical for growing companies, but it's important to understand what those investments are.

Step 4: Analyze Cash Flow from Financing Activities

* **Review Debt Activity:** Analyze cash inflows from borrowing and cash outflows for repaying debt. Understand the company's debt management strategy.

* **Analyze Equity Transactions:** Look at cash flows from issuing or repurchasing stock. Stock repurchases can return cash to shareholders but can also indicate a lack of other investment opportunities.

* **Review Dividend Payments:** Cash outflows for dividends represent returns to shareholders.

* **Understand the Funding Mix:** How is the company funding its operations and growth (through debt, equity, or internally generated cash)?

Step 5: Analyze the Net Change in Cash and Cash Equivalents

* **Reconcile to the Balance Sheet:** The net change in cash and cash equivalents reported on the SCF should reconcile with the change in the cash and cash equivalents balance on the balance sheet between the beginning and end of the period.

Step 6: Analyze Key Ratios and Relationships

* **Free Cash Flow (FCF):** A measure of the cash flow available to the company after accounting for capital expenditures. It can be calculated as:

$$\text{FCF} = \text{Cash Flow from Operations} - \text{Capital Expenditures}$$

Positive and growing FCF is generally a good sign.

* **Current Ratio and Quick Ratio:** While these are balance sheet ratios, consider them in the context of cash flow. A strong current ratio combined with positive operating cash flow indicates a good ability to meet short-term obligations.

* **Cash Flow to Debt Ratio (Cash Flow from Operations / Total Debt):** Indicates the company's ability to repay its debt with cash generated from operations. A higher ratio is generally better.

Step 7: Read the Notes to the Financial Statements (Again!)

* **Important Details:** The notes can provide details about non-cash investing and financing activities (e.g., acquiring assets through finance leases), significant cash outlays, and other relevant information.