Part One

FUNDAMENTALS

1

STARTING WITH CASH FLOWS

Cash Flows Summary for a Business

Savvy business managers, lenders, and investors pay a lot of attention to *cash flows*. Cash inflows and outflows are the heartbeat of every business. Without a steady heartbeat of cash flows, a business would soon have to go on life support, or die.

So, we start with cash flows. For our example we use a business that has been operating many years. This established business makes profit regularly and, equally important, it keeps in good financial condition. It has a good credit history, and banks lend money to the business on competitive terms. Its present stockholders would be willing to invest additional capital in the business, if needed. None of this comes easy. It takes good management to make profit consistently, to secure capital, and to stay out of financial trouble. Many businesses fail these imperatives, especially when the going gets tough.

Exhibit 1.1 summarizes the company's cash inflows and outflows for the year just ended, and shows two separate groups of cash flows. First are the cash flows of its profit-making activities—cash inflows from sales and cash outflows for expenses. Second are the other cash inflows and outflows of the business—raising capital, investing capital in assets, and distributing some of its profit to shareowners.

We assume you're fairly familiar with the cash inflows and outflows listed in Exhibit 1.1. Therefore, we are brief in describing the cash flows at this early point in the book:

- The business received $51,680,000 during the year from selling products to its customers. It should be no surprise that this is its largest source of cash inflow. Cash inflow from sales revenue is needed for paying expenses. During the year the company paid $34,760,000 for the products it sells to customers. And, it had sizable cash outflows for operating expenses, interest on its debt (borrowed money), and income tax. The net result of its cash flows of profit-making activities is a $3,105,000 cash increase for the year—an extremely important number that managers, lenders, and investors watch closely.

- Moving on to the second group of cash flows during the year, the business increased the amount borrowed on notes payable $625,000, and its stockholders invested an additional $175,000 in the business. Together these two external sources of capital provided $800,000, which is in addition to the internal $3,105,000 cash from its profit-making activities during the year. On the other side of the ledger, the business spent $3,625,000 for building improvements, for new machines and equipment, and for intangible assets. Finally, the business distributed $750,000 cash to its stockholders from profit. This distribution from profit is included in the second group of cash flows. In other words, the $3,105,000 cash flow from profit is before the distribution to shareowners.

- The net result of all cash inflows and outflows is a $470,000 cash *decrease* during the year. Don't jump to any conclusions; the net decrease in cash in and of itself is neither good nor bad. You need more information than just the summary of cash flows to come to any conclusions about the financial performance and situation of the business.

EXHIBIT 1.1—SUMMARY OF CASH FLOWS DURING YEAR

Dollar Amounts in Thousands

Cash Flows of Profit-Making Activities	
From sales of products to customers, which includes some sales made last year	$ 51,680
For acquiring products that were sold, or are still being held for future sale	$(34,760)
For operating expenses, some of which were incurred last year	$(11,630)
For interest on short-term and long-term debt, some of which applies to last year	$ (520)
For income tax, some of which was paid on last year's taxable income	$ (1,665)
Cash flow from profit-making activities during year	$ 3,105
Other Sources and Uses of Cash	
From increasing amount borrowed on interest-bearing notes payable	$ 625
From issuing additional capital stock (ownership shares) in the business	$ 175
For building improvements, new machines, new equipment, and intangible assets	$ (3,625)
For distributions to stockholders from profit	$ (750)
Net cash decrease from other sources and uses of cash	$ (3,575)
Net cash increase (decrease) during year	$ (470)

What Does Cash Flows Summary *Not* Tell You?

In Exhibit 1.1 we see that cash, the all-important lubricant of business activity, decreased $470,000 during the year. In other words, the total of cash outflows exceeded the total of cash inflows by this amount for the year. The cash decrease and the reasons for the decrease are important information. The cash flows summary tells an important part of the story of the business. But, cash flows do not tell the whole story. Business managers, investors in a business, business lenders, and many others need to know two other types of information about a business that are *not* reported in its cash flows summary.

The two most important types of information that a summary of cash flows does not tell you are:

1. The profit earned (or *loss* suffered) by the business for the period.
2. The financial condition of the business at the end of the period.

Now hold on. Didn't we just see in Exhibit 1.1 that the net cash increase from sales revenue less expenses was $3,105,000 for the year? You may ask: "Doesn't this cash increase equal the amount of profit earned for the year?" No, it doesn't. The net cash flow from profit-making operations during the year does not equal the amount of profit earned for the year. In fact, it's not unusual that these two numbers are very different.

Profit is an *accounting-determined* number that requires much more than simply keeping track of cash flows. The differences between using a checkbook to measure profit and using accounting methods to measure profit are important to understand. Hardly ever are cash flows during a period the correct amounts for measuring a company's sales revenue and expenses for that period. Summing up, profit cannot be determined from cash flows.

Furthermore, a summary of cash flows reveals virtually nothing about the *financial condition* of the business. Financial condition refers to the assets of the business matched against its liabilities at the end of the period. For example: How much cash does the company have in its checking account(s) at the end of the year? From the summary of cash flows (Exhibit 1.1) we see that the business decreased its cash balance $470,000 during the year. But we can't tell from the cash flows summary the company's ending cash balance. And, more importantly, the cash flows summary does not report the amounts of assets and liabilities of the business at the end of the period.

Profit Cannot Be Measured by Cash Flows

The company in this example sells products on *credit*. The business offers its customers a short period of time to pay for their purchases. Most of the company's sales are to other businesses, which demand credit. (In contrast, most retailers selling to individuals accept credit cards instead of extending credit to their customers.) In this example the company collected $51,680,000 from its customers during the year. However, some of this cash inflow was for sales made in the *previous* year. And, some sales made on credit in the year just ended had not been collected by the end of the year.

At year-end the company had *receivables* from sales made to its customers during the latter part of the year. These receivables will be collected early next year. Because some cash was collected from last year's sales and some cash was not collected from sales made in the year just ended, the total amount of cash collections during the year differs from the amount of *sales revenue* for the year.

Cash disbursements during the year are *not* the correct amounts for measuring expenses. The company paid $34,760,000 for products that are sold to customers (see Exhibit 1.1). At year-end, however, many products were still being held in *inventory*. These products had not yet been sold by year-end. Only the cost of products sold and delivered to customers during the year should be deducted as expense from sales revenue to measure profit. Don't you agree?

Furthermore, some of the company's product costs had not yet been paid by the end of the year. The company buys on credit and takes several weeks before paying its bills. The company has *liabilities* at year-end for recent product purchases and for operating costs as well.

Its cash payments during the year for operating expenses, as well as for interest and income tax expenses, are not the correct amounts to measure profit for the year. The company has liabilities at the end of the year for *unpaid expenses*. The cash outflow amounts shown in Exhibit 1.1 do not include the amounts of unpaid expenses at the end of the year.

In short, cash flows from sales revenue and for expenses are not the correct amounts for measuring profit for a period of time. Cash flows take place too late or too early for correctly measuring profit for a period. Correct timing is needed to record sales revenue and expenses in the right period.

The correct timing of recording sales revenue and expenses is called *accrual-basis accounting*. Accrual-basis accounting recognizes receivables from making sales on credit and recognizes liabilities for unpaid expenses in order to determine the correct profit measure for the period. Accrual-basis accounting also is necessary to determine the financial condition of a business—to record the assets and liabilities of the business.

Cash Flows Do Not Reveal Financial Condition

The cash flows summary for the year (Exhibit 1.1) does not reveal the financial condition of the company. Managers certainly need to know which assets the business owns and the amounts of each asset, including cash, receivables, inventory, and all other assets. Also, they need to know which liabilities the company owes and the amounts of each.

Business managers have the responsibility for keeping the company in a position to pay its liabilities when they come due to keep the business *solvent* (able to pay its liabilities on time). Business managers also have to keep the business *liquid* (having enough available cash when you need it). Furthermore, managers have to know whether assets are too large (or too small) relative to the sales volume of the business. Its lenders and investors want to know the same things about a business.

In brief, both the managers inside the business and lenders and investors outside the business need a summary of a company's financial condition (its assets and liabilities). They need a profit performance report as well, which summarizes the company's sales revenue and expenses and its profit for the year.

A cash flows summary is useful. In fact, a slightly different version of Exhibit 1.1 is one of the three primary financial statements reported by every business, but in no sense does the cash flows report take the place of the profit performance report and the financial condition report. The next chapter introduces these two financial statements, and shows the generally accepted format of a summary of cash flows (instead of the informal format shown in Exhibit 1.1).

A Final Note before Moving On

Over the past century (and longer) a recognized profession has developed, one of whose main functions is to prepare and report business financial statements—the *accounting profession*. A primary goal of the accounting profession has been to develop and enforce accounting and financial reporting standards that apply to all businesses. In other words, there is a "rule book" that businesses should obey in accounting for profit and in reporting profit, financial condition, and cash flows. Businesses are not free to make up their own individual accounting methods and financial reporting practices. The established rules and standards are collectively referred to as *generally accepted accounting principles* (GAAP). But things are getting more complicated these days, that's for sure.

In the United States there are serious beginnings to adopt separate rules for private companies versus public companies, and for small companies versus larger companies. Furthermore, the efforts to develop international accounting and financial reporting standards keep slogging along, with mixed results so far. We say more about the changing landscape of accounting and financial reporting standards in Chapter 23.