

Part One

FUNDAMENTALS

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STARTING WITH CASH FLOWS

Summary of Cash Flows for a Business

Savvy business managers, lenders, and investors pay a lot of attention to *cash flows*. Cash inflows and outflows are the pulse 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.

Cash inflows and outflows appear in a summary of cash flows. For our example in Exhibit 1.1, we use a business that has been operating for 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 by \$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, new machines and equipment, and intangible assets. Finally, the business distributed to its stockholders \$750,000 cash from profit. This distribution from profit is included in the second group of cash flows, indicating that the \$3,105,000 cash flow from profit is the net cash flow *before* the distribution to stockholders.

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	<u>\$ (1,665)</u>
<i>Net cash flow from profit-making activities during year</i>	<u>\$ 3,105</u>

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	<u>\$ (750)</u>
<i>Net cash decrease from other sources and uses</i>	<u>\$ (3,575)</u>
Net cash increase (decrease) during year	<u><u>\$ (470)</u></u>

- ♦ The net result of all cash inflows and outflows is a \$470,000 cash *decrease* during the year. When you see a decrease, don't jump to any conclusions. In and of itself, the net decrease in cash is

neither good nor bad. You need more information than appears on the summary of cash flows to come to any conclusions about the financial performance and situation of the business.

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 period (in this case, a year). In other words, the total of cash outflows exceeded the total of cash inflows by this amount for the period. The cash decrease and the reasons for it are important information. The summary of cash flows tells us part of the story, but cash flows alone do not tell the whole story. A business's managers, investors, lenders, and other stakeholders need to know two additional pieces of information that are *not* reported in an organization's summary of cash flows. They 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. Exhibit 1.1 just informed us that the net cash increase from sales revenue less expenses was \$3,105,000 for the year. This may lead you to 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 period does not equal the amount of profit earned for the period. In fact, it's not unusual for these two numbers to be 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. Cash flows during a period are *hardly ever* the correct amounts for measuring a company's sales revenue and expenses for that period. To summarize: 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 can see that the business decreased its cash balance \$470,000 during the year, but we cannot determine the company's ending cash balance. 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 Is Not 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 could be sold to customers. 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 to pay its bills. The company has *liabilities* at year-end for recent product purchases and for operating costs. Further complicating the situation, the company makes cash payments during the year for operating expenses and interest and income tax expenses, but these are not the correct amounts for measuring 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 necessarily the correct amounts for measuring profit for a period of time. Many types of cash flows take place too late or too early so they cannot be used to correctly measure profit for a period. Correct timing is needed to record sales revenue and expenses in the right period. The amounts of cash flows caused by sales and expenses could turn out to be fairly close to the correct accounting amounts—or, they could be vastly different. Even small differences between the cash flow amounts and the correct accounting amounts can cause problems.

Cash Flows Do Not Reveal Financial Condition

The cash flows summary for the year 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, which can include cash, receivables, inventory, among others. 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. In other words, managers have to keep the business *solvent* (able to pay its liabilities on time) and *liquid* (having enough available cash to meet its needs). Furthermore, managers have to know whether assets are too large (or too small) relative to the sales volume of the business. A company's lenders and investors want to know the same things.

In brief, both the managers inside the business and the lenders and investors outside the business need a summary of a company's

financial condition (its assets and liabilities). They also need a profit performance report, which summarizes the company's sales revenue, expenses, and profit for the year.

In this chapter we have explained that a cash flows summary has its limits—in particular, it does not report profit and does not present the financial condition of a business. Nevertheless, a cash flows summary is useful. In fact, a different version of what is shown in Exhibit 1.1 is one of the three primary financial statements reported by every business. But in no sense does a cash flows summary take the place of the profit performance report or the financial condition report. The next chapter introduces these two financial statements. Chapter 3 then moves on to the statement of cash flows, which is a more formal financial statement than the summary discussed in this chapter.

A Final Note Before Moving On

Over the past century (and longer) the *accounting profession* has developed. One of its main functions is to prepare and report business financial statements. 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 an authoritative “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.

Presently in the United States there are continuing developments to adopt separate rules for private companies versus public companies, and for small companies versus larger companies. Furthermore, efforts to harmonize American accounting and financial reporting standards with those of other countries keep slogging along. There has been a lot of standardization. Yet, there are several areas of accounting and financial reporting in which there are differences between countries. We say more about the changing landscape of accounting and financial reporting standards in later chapters.

