Section One
Historic Cash Flow Analysis

1

Understanding How Cash Flows in a Business

INTRODUCTION

This chapter is designed to enable those with less direct experience of the operation of businesses to grasp the fundamental financial and economic logic that governs how successful businesses operate. It represents the starting point for our journey through the landscape of cash flow analysis. In order to gain benefit from this chapter no prior knowledge of either cash flow or business is required.

We start our journey by developing a model of how the cash flows in a simple business work. We then develop our knowledge of cash flows by incrementally adding complexity to this model.

Whilst developing this model based on the cash flows of a business we also introduce some fundamental logic about what different types of business must do in order to be successful.

THERE IS NOTHING NEW ABOUT BUSINESS

Humans have been engaging in trade for thousands of years, initially through some sort of barter process. Archaeologists have discovered ancient manufactured goods such as pottery and metal objects that have travelled vast distances from their point of manufacture. There are numerous examples of early Greek and Roman shipwrecks being discovered in many different parts of the Mediterranean dating back 2000 years or more. In the 1960s evidence was finally discovered that proved that the Vikings were the first Europeans to discover America some 500 years before Columbus. The remains of a Norse settlement at L'Anse aux Meadows on the northern tip of Newfoundland have been authenticated and dated to around 1000AD. During the excavation of the site over 100 objects of European manufacture were unearthed.

A more recent development in human history was the introduction of money in the form of coinage and, later, notes. Whilst there is much debate about what should be recognised as the first coin, a good candidate would be a small lump of electrum (a natural alloy of gold and silver) stamped with a design and minted around 600BC in Lydia, Asia Minor (now known as Turkey). Paper money seems to have emerged in China at about the same time.

This innovation, together with many others such as agriculture, settlements, the wheel and writing led to the modern, technologically based world economy we have today. Trade or business, in one form or another, has probably been part of the human condition from our earliest origins.

UNDERSTANDING MONEY IN BUSINESS

We are going to start with two simple examples of business activity. The first one represents one of the simplest forms of business. (More complex business examples follow over the next few pages.)

The Simplest Form of Business

Newspaper vending, by which I mean the activity of selling newspapers to passers-by on a street corner, is a good example of a really simple business. The vendor, or businessman, buys the newspapers from the publisher or a wholesaler and then retails them to passers-by for a price that gives him a margin over the cost of purchasing the newspapers.

A second example of a really simple business is an antique dealer, someone who buys and sells old objects. We will work with this example from now on.

The Debate About the Purpose and Objectives of a Business

The varying cultures around the world place different emphasis on how the benefits generated by a successful business should be shared amongst its stakeholders. I do not propose to examine the merits or otherwise of these views. There is considerable literature on what measures should be used to assess success or failure in business. Both growth and profit increase look like good candidates but fail as measures of success if the improvement in growth or profits is achieved by investing disproportionate amounts of cash. I do not propose to go much further with this debate other than to say that increasing the value of a business over time is now considered the most appropriate measure of success. This is achieved by continually improving the present and future cash flows of a business on an ongoing basis.

So, at this point in my explanation, I am assuming that the business I am describing is being run with the objective of wealth maximisation for the owners. For the purposes of this book I define that as maximising the future cash flows of the business.

The Objective of Being in Business is to Generate *More Cash*

It is important to introduce the purpose of a business here because specifying the objective of the business defines the task of the business person, entrepreneur, manager or other business controller (which is to get *more cash*). In both the business examples introduced so far we have a trader or dealer who buys and sells, typically without changing or modifying the items traded in any way. This is the simplest form of business.

The trader's objective is to generate more cash than they started with. (Note that I have not used the terms *profit* or *gain* as we are developing a model containing only items that represent the cash flows in a business. What we mean by profit is actually quite an abstract concept. This is dealt with in more detail in Chapter 12.)

How Does a Trading Business Add Value?

An initial observation might be that these businesses make money by buying things for less than they can sell them. While this is an accurate observation of what a successful trading business does, this fails to explain why or how the business is able to achieve this beneficial outcome.

What is the key skill for an antique dealer? Is it knowledge of the antiques traded in? Whilst this may help, much of this information is available from books. Is it renovation skills? Again this may or may not add value to the items being renovated depending on consumer taste at the time. The key skill is probably, knowing where to buy cheaply and where to sell expensively. Here is an example of what I mean.

For many years the typical vehicle of choice for a British antique dealer has been the Volvo estate, which is used to travel to distant parts of Scotland and Wales so that the dealer can purchase furniture and other antiques from remote house sales and auctions where they are often sold cheaply. The goods purchased are then transported to London where they can be auctioned through the major auction houses or retailed to wealthy collectors at collectors' fairs or from retail premises.

What this antique dealer is doing is relocating the goods traded from a place where they can be bought cheaply to a place where they can be sold more expensively. It's all about the relocation of the goods. Why is this so important?

Consider what happens when you get up in the morning. Do you travel to Java for your coffee beans, Florida for your orange juice, Jamaica for your sugar, and to your local farm for your milk?

This is unlikely. What most of us do is go to the nearest convenience store, which may be just down the street and buy what we wish to consume for our breakfast. So, what then is the owner of the convenience store doing to add value? What he does is relocate a range of goods he knows we are likely to consume for

breakfast to a place convenient for us to make our purchases as consumers. The convenience of the location is the most important thing, the goods offered are in a sense irrelevant, they are whatever we want to consume.

So, the key to most trading, retail and wholesale businesses is location. What these businesses do is relocate goods from their places of production or, if second-hand, their present location, to a location convenient for the target consumer to consume them. It follows that there is little point in locating a business in a remote part of the world as there are few consumers there! The ideal location for newspaper vending is directly outside a major railway station in central London or any other major city in the world, this is where you will have thousands of potential consumers passing by every hour of the working day. In other words, you will sell more newspapers. The location is the essence of the business's ability to generate cash.

So, the cash flows of our simplest business look like the model shown in Fig. 1.1. Overheads is the term commonly used in business to refer to all the costs of trading other than inventory costs.

Using CASH the trader makes purchases of goods, which he holds as INVENTORY. Some time later he resells the goods acquired for more than he paid for them, receiving cash in exchange for the items. He will typically incur some OVERHEADS in the process, in our example of the antique dealer these will be transport, location and communication costs.

This is effectively all a trading, retail or distribution business does, repeating the journey round the circle many times. Now let us look at a more complex business, one where work is performed on the purchased inputs of the business.

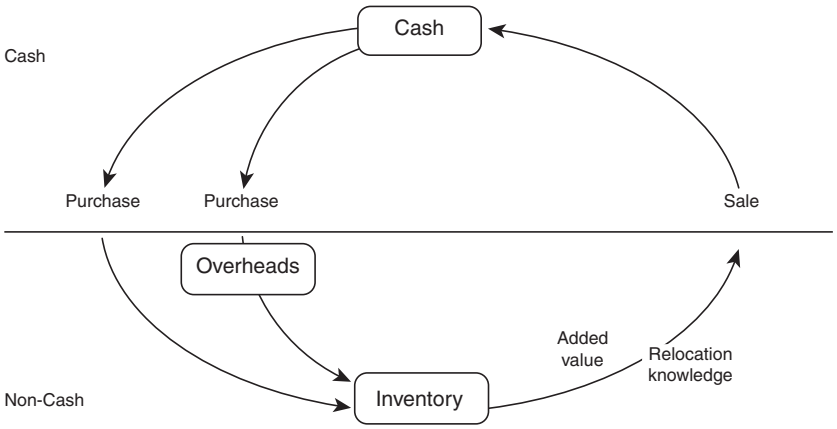

Figure 1.1 Diagram of the cash flows of a simple trading business

THE SIMPLE MANUFACTURING BUSINESS

In my other life as a financial trainer I have travelled all over the world offering training seminars on financial analysis and related subjects. One of the places I have visited on my travels is Nairobi in Kenya. When travelling from Nairobi airport to the training location I noticed business people selling beds and other simple items of furniture outside their workshops by the side of the road. This then is the next example we will examine; a simple manufacturing business.

How Does a Simple Manufacturing Business Add Value?

What do manufacturers do to create wealth for themselves? They take raw materials and change them into something more useful; economists talk about adding utility. For example, I could sleep on a log. However, this would not be particularly comfortable, the bark would make my back itch and I might roll off! If the log is cut up into timber and then turned into a bed frame I am likely to be willing to pay more for it in this form. Now, I could of course do this myself with the aid of a saw and a few basic woodworking tools, so why do I not normally bother? There are three reasons: time, quality and cost. I could make the bed, but it would take me three days whilst the manufacturer does it in half an hour. Secondly, the result I achieve might not have the quality of the professionally manufactured alternative and, finally, it would almost certainly be more expensive when the opportunity cost of my time as well as the cost of the raw materials is taken into account.

So, manufacturers do not just convert things (raw materials) into more useful things (finished goods), they are experts at the process of doing so. Successful manufacturers do it very quickly and efficiently to a very high standard. The key word here is *expert*. If you are analysing the performance of a manufacturing business and find that it receives many customer complaints and returned goods due to manufacturing defects, or is experiencing significant difficulties actually producing goods, this suggests they are not experts. To use a metaphor: it implies they are amateurs rather than professionals. Any business being operated in a non-professional way is at a higher risk of poor financial performance and eventual failure than its more professional and competent competitors. The extreme levels of professionalism required just to be competitive in most manufacturing activities is simply a consequence of competition over long periods of time.

So the cash flows of our simple manufacturing business look like the model shown in Fig. 1.2.

Using CASH the manufacturer makes a purchase of RAW MATERIALS and does work on them, so converting them to WORK IN PROGRESS and eventually FINISHED GOODS. These items being akin to INVENTORY in our previous model. Some time later he resells the finished goods for more than the cash costs of producing them, receiving cash in exchange for the items. He will typically

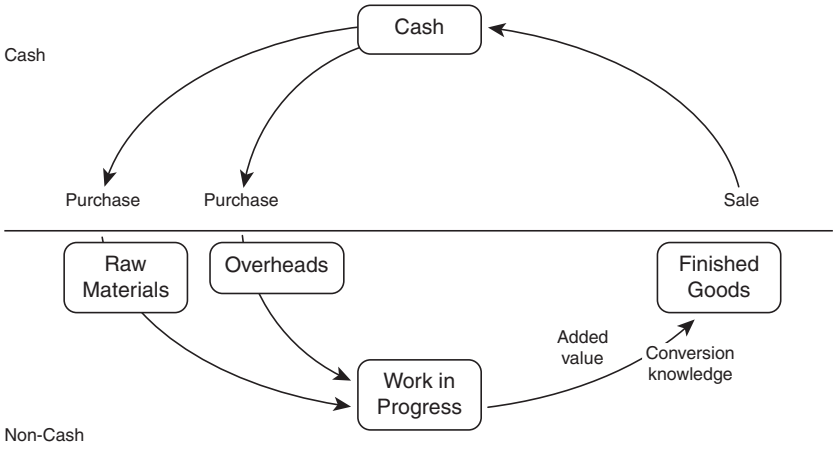

Figure 1.2 Diagram one of the cash flows of a manufacturing business

incur some OVERHEADS in the process of conversion, these being purchasing, manufacturing, premises, and selling costs in our example.

This is what the cash flows of a new small manufacturing business look like. Cash is generated by repeating the journey round the circle many times. Now let us see how this develops as the business evolves over time.

Developing Our Model – the Next Step

Continuing with our example of an African entrepreneur who has recently established himself as a manufacturer of furniture, let us assume his new business is successful. Our entrepreneur is working many hours a day and all the product he produces sells well. What is likely to be his first major issue in developing his business?

Given his location his next move is most likely to be adding labour to the business to increase output and hence cash flow. This is because there is much labour available and, given the emerging market location of the business, this labour is available relatively cheaply (Fig. 1.3).

LABOUR now joins overheads as an item purchased and consumed by the business to add value to raw materials.

If our entrepreneur furniture designer was in Munich in Germany the decision might be quite different. In this location the economic environment is different to that in Nairobi in Kenya. In Germany labour costs are significantly higher per hour and employees are protected in many ways by a mass of social legislation

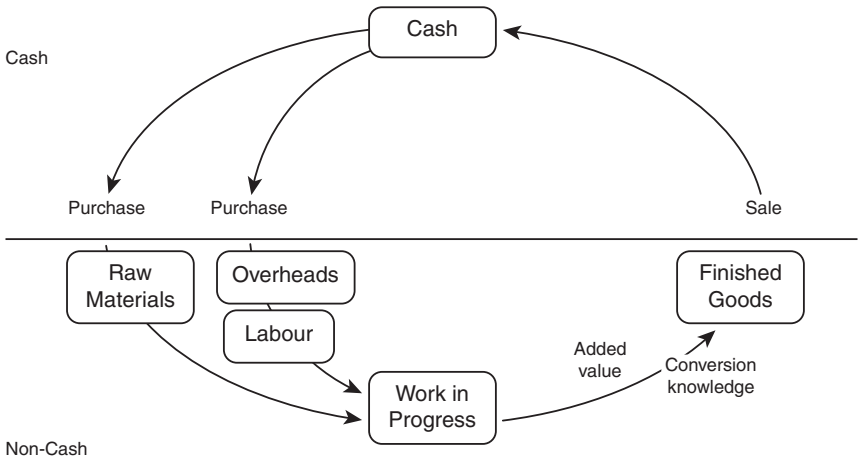

Figure 1.3 Diagram two of the cash flows of a manufacturing business

giving them extensive rights and obliging employers to compensate employees in the event of job losses. From an economic point of view the cost of labour is higher and the cost itself is less variable. In Germany the first major initiative to build our business is more likely to be the purchase of machinery (i.e. fixed assets) to increase output and hence cash flow, rather than the addition of more labour (Fig. 1.4).

Why is the decision different depending on the location of the business? This is because the economic environment is different. Factors that affect the decision of whether to employ labour or purchase fixed assets would be things like, the law and regulations affecting the cost and flexibility of labour, the local environment governing labour and investment in fixed assets, and the availability and quality of labour.

There are other issues that might inform or determine the decision. Machines have certain characteristics that could arguably make them superior to labour in many situations. They do not go on strike; they can, assuming they are properly maintained, produce a succession of perfect and identical output 24 hours a day without requiring sleep or food. But, there are also some key negative characteristics of machines. They usually require infrastructure such as electricity, gas, compressed air and water constantly available without interruption. They are very good at doing the same thing again and again; they are not so good when the required output keeps changing. Any change to the product manufactured may necessitate hours of re-engineering and re-programming of the machine before productive output recommences.

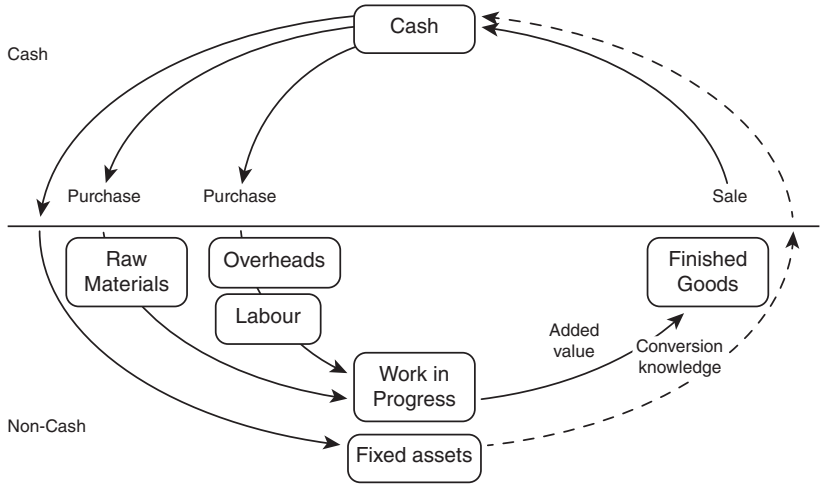

Figure 1.4 Diagram three of the cash flows of a manufacturing business

Labour, despite its imperfections, is very flexible. It can make the tea, collect the raw materials, deliver finished product and paint the wall, in addition to being available to produce product as required. It copes well with a succession of variable tasks. The negatives are that it can go on strike, it requires a safe and healthy working environment and protection from the risk of injury or death (known collectively as health and safety). It also needs constant breaks for food and rest, and it can produce substandard and defective work if not properly trained and supervised.

So, labour is flexible but inconsistent, machinery is inflexible but consistent. As our example business grows, whether situated in Kenya or Germany, labour and fixed assets will be added as required according to their relative utility to cost in the local environment.

You may have noticed the use of a dotted line to denote the sale of fixed assets. This is because when we acquire fixed assets we intend to keep them to assist us in the process of producing or trading our goods and services. We do not intend to sell them or trade them during their useful lives. Only when they are no longer of operational use to us do we sell them if we can. The cash flow we get when we sell them is usually small relative to the cash flow spent on new assets.

The Consequences of Growth and Success

As the business develops it becomes more complex, typically because growth means an increase in everything. The numbers of labour, machines, products,

customers and suppliers can all increase. With this complexity comes new risks. When a business is small it can be controlled by one person. As it grows this becomes more and more difficult because too many things that require control are happening simultaneously. Delegation of authority to others is required, which implies the creation of a management structure.

Similarly the cash flows involved in the business all get larger. Turnover, costs, investment, debtors and creditors all increase. At this point it is sensible to consider limiting the risk of the owner. How can this be achieved?

The owner can sell the business to a limited company owned by him or herself. Until this point our example business has been trading as a sole trader. In English law there are three different ways a person can trade, as a sole trader, as a partner in a partnership and through the use of some sort of company owned by the person.

As a sole trader or partner an individual's risk is unlimited. Should there be any negative event that results in significant liabilities for the business in which they are involved, the sole trader and any partner are personally liable for the full amount. Should a business operating as a limited company suffer an event that leads to huge liabilities the company itself is the party responsible for the liabilities, not the owners. The owners are only liable to the extent they have subscribed for shares, (in other words they may lose the equity they own in the company). As long as the directors have acted lawfully they cannot be made personally liable for the liabilities of the company. This means if the company collapses into bankruptcy the director owner can keep his house, pension fund and other personal assets that are separate from the limited company in which the business resides.

So, from a risk management viewpoint, are companies a good idea or a bad idea? For society as a whole they appear to be a good idea, partly because they facilitate the pooling of investment for new projects. A developed nation has extensive infrastructure in the form of roads, railways, airports, pipelines, communications, electricity and oil and gas infrastructure which requires the capital of hundreds of thousands of individuals to create. By issuing shares to millions of people, each of which is a part owner of the business, these beneficial assets for society can be created and maintained. They also encourage risk-taking in the form of new business creation because entrepreneurs can protect their personal assets by using a limited company as the vehicle for their new ventures.

The negative aspects of companies arise if you are a creditor of a company. Banks, suppliers and employees lose money when companies fall into bankruptcy. In extreme situations a limited company can be used deliberately to acquire the cash flow of a business, which is then stolen by the owners. This is of course criminal and fraudulent. This is why it is essential that stakeholders who are creditors monitor the creditworthiness (or credit risk) of any company they are involved with as a creditor.

Figure 1.5 introduces equity (and debt) to the model.

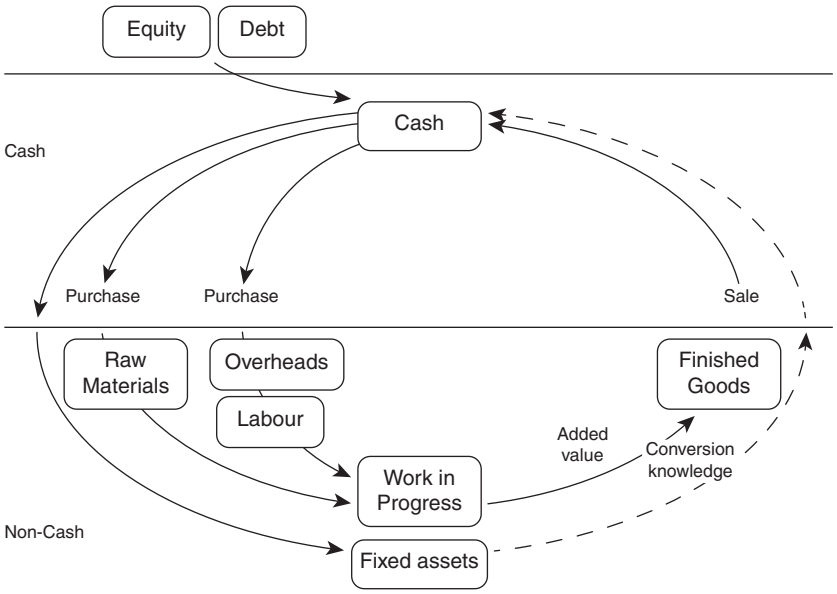

Figure 1.5 Diagram four of the cash flows of a manufacturing business

The business is now owned by an independent legal entity (a company) that is separate from the person or persons who formerly owned it. Their interest is represented by their shareholding in the EQUITY of the company. The company may also have raised cash to invest in the company by borrowing, perhaps from a bank, which is recognised in Fig. 1.5 as DEBT.

Debt, in the form of loans or leases may be used by the company to acquire fixed assets such as factory premises and machines. Debt may also be used to provide working capital in the form of an overdraft facility or via the use of factoring or invoice discounting.

Having introduced these new sources of capital we need to add further items to the model to keep it consistent with reality. Cash borrowed from banks is not lent for nothing. Banks charge INTEREST (essentially a rent) for the period that the money is advanced to the borrower. Similarly, if the company is successful it may pay DIVIDENDS to its shareholders. Finally, most governments demand that the company pay TAXATION on any taxable profits from trading or other investment income generated by the company.

These potential cash outflows do not represent operating costs because they arise for reasons that differ from the other cash outflows required to operate the

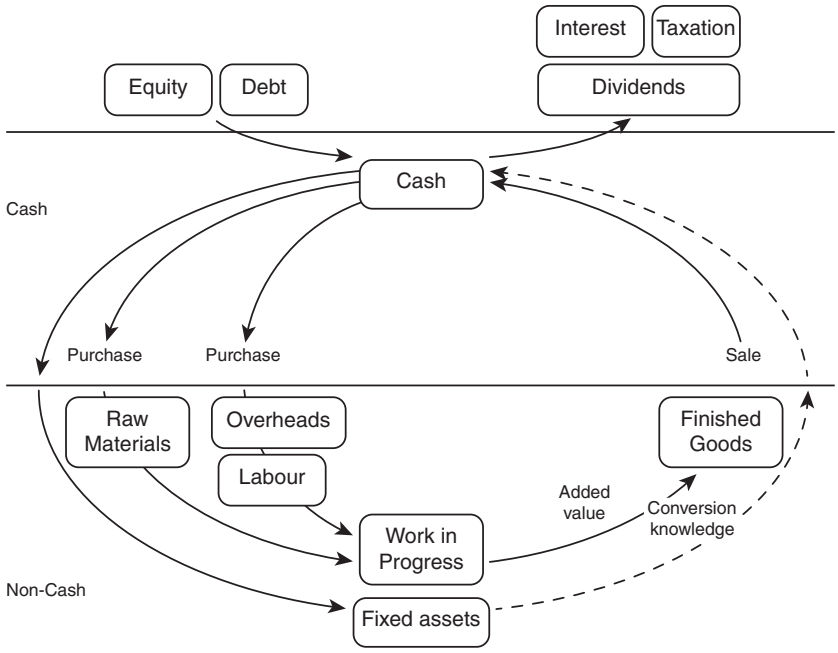

Figure 1.6 Diagram five of the cash flows of a manufacturing business

business. DIVIDENDS and INTEREST represent rewards paid to financiers as a consequence of their investment. TAXATION is a government levy on surpluses generated by the company. All the other operating costs of the business should be incurred because they are necessary in order to generate the operating cash flow of the business. When we add these items our model of the cash flows of the business looks like Fig. 1.6.

The Implications of Supplier and Customer Credit

So far we have assumed that all transactions in the business take place in cash. In the real world this is not so. There is often a difference between the time we take physical delivery of something we have purchased and when we pay for it. Conversely, it is common to sell something to a customer allowing them a period of time to pay, the cash due on the sale of the product being received some time later.

Let us consider the example of our business of our African entrepreneur some years on. He is no longer manufacturing furniture outside his home; he now has a substantial factory full of machinery and labour, owned by a limited company controlled by him.

When he buys timber he does not collect it on foot with a handcart any more. He telephones his timber merchant and asks him to deliver three truckloads of timber. When the timber arrives he does not pay for it, he signs a delivery note. A CREDITOR (or PAYABLE) is created at this point (being the money due to the supplier in payment for the goods) which may be settled (paid) one to three months later.

Similarly when the business sells a bed it is no longer sold for cash on the side of the road. Instead the beds are now manufactured in the form of flat packs, stuffed in a container and sent to IKEA, a major global discount furniture retailer. When IKEA receive the beds they do not pay cash, they sign a delivery note for the goods and create a DEBTOR (or RECEIVABLE), (being the money due from the customer for the goods sold to them) which may be settled one to three months later.

So, CREDITORS effectively grant the business a short-term interest-free loan whilst the liability to them remains unpaid. Conversely, our furniture business essentially lends its DEBTORS short-term, interest-free funds for the duration of the period whilst the debt owed to the furniture business remains unpaid.

These time delays have a substantial and important effect on the cash flows of a business and must therefore be incorporated in our model. Our model now evolves further (Fig. 1.7).

The model is now essentially complete; it contains all the cash flows relating to a single business entity. We can see clearly how the cash flows round a business. Having constructed this model, we can now work with it to develop our understanding of cash flow and business practice. What else is important to our understanding of cash flow?

The Working Capital Cycle

We can now see that cash flows round the business as follows:

1. The business orders goods and services (these being either RAW MATERIALS, LABOUR or OVERHEADS).
2. The goods and services are delivered, creating a CREDITOR. They enter production or are consumed in the production process.
3. The RAW MATERIALS are converted into WORK IN PROGRESS and finally FINISHED GOODS.
4. The FINISHED GOODS are then sold, creating a DEBTOR.
5. The DEBTOR pays the invoice some time later providing CASH to the business.
6. The CASH is used to pay CREDITORS as they fall due.

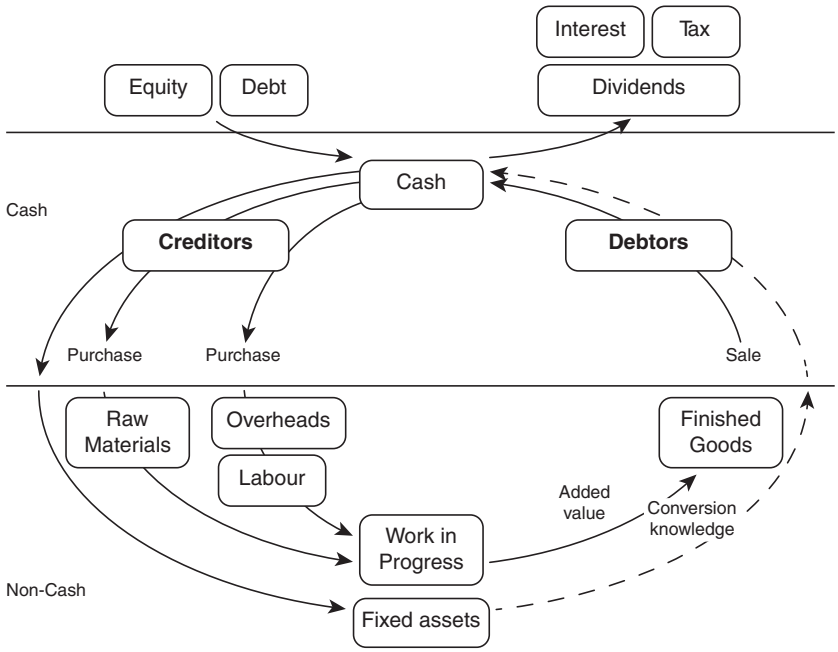

Figure 1.7 Diagram six of the cash flows of a manufacturing business

This movement of cash and resources around the business is known as the WORKING CAPITAL CYCLE. It represents the most active and volatile set of cash flows through most businesses. It is the most demanding area of cash management to control. Experienced managers know that managing the working cash flows is a demanding exercise. Most of the daily tasks of management arise from problems achieving the timely supply of goods and services at the right level of quality to the business, and the problems of manufacturing the product right first time without quality defects. Both tasks have to be satisfactorily completed before delivery and invoicing can take place in turn resulting in cash flow from customers to the business.

The investment requirements of a business and the amount of business risk inherent in a particular business are both affected by the nature and behaviour of the working capital cycle. Understanding the working capital cycle is therefore very important. The main problem is recognising the risk implications – of the impact of time – on the business.

You may be wondering what time has to do with all this. *Timing is the essence of working capital management* which, in turn, is the key component of cash flow management. Let us take two examples:

On day one Tesco plc (a leading UK supermarket group) orders a truckload of beans from Heinz plc (a major global food manufacturer). The beans arrive at Tesco's distribution depot on day three and arrive in the store on day four. By the end of day five all the beans are sold to customers for cash or credit card payment with Tesco in possession of cleared funds by day seven. Tesco then holds the cash for 53 days before paying Heinz for the beans. Contrast this with Airbus Industrie (a major civil aircraft manufacturer) who are constructing an Airbus A380 for a major airline.

Following years of negotiation Airbus receives an order for a number of aircraft, this in turn initiates the thousands of orders necessary to obtain the various components and sub-assemblies required from their respective suppliers. Over a period of many months raw materials are received and the aircraft is assembled (being work in progress at this point, which takes about 12 months), then completed and tested (becoming finished goods at this point). Finally, after further performance tests by Airbus and the purchasing airline the aircraft is accepted into service and paid for. The journey round the working capital cycle takes between one and two years.

What conclusions can we draw from these two deliberately extreme examples? If Tesco has agreed 60 day settlement terms with Heinz they will be able to sell the beans and hold the resultant cash for 53 days before settling their liability to Heinz. In other words Tesco plc *generates cash from the working asset cycle as a consequence of trading. No external finance is required to trade. All the cash required comes from credit provided by suppliers*. The operating creditors of Tesco exceed the inventory and there are no debtors. Where the operating creditors of a business exceed the amounts invested in the inventory and operating debtors of a business we say the business has *negative* net working asset investment. In this situation the more turnover *increases* the more *cash is generated* from working assets. Another way of illustrating the benefits of this is that Tesco would have the benefit of this cash for 53 days and be able to earn interest on it even if Tesco *sold the goods acquired with trade credit at the same price they were purchased from the supplier.*

Airbus Industrie enjoys much less favourable working asset behaviour. They have to invest many millions of euros in the working capital cycle to manufacture each Airbus A380. The funding of the working capital requirement for each major contract is a major undertaking. Each aircraft sells for approximately $US320 million. The more successful Airbus is at selling the Airbus A380 aircraft the more cash has to be found to invest in working capital. *Airbus has to invest vast sums into the working asset cycle in order to trade. Increased trading requires more cash to be invested in the working capital cycle. Airbus has positive working asset investment. No cash is generated from working assets; as the business grows cash is typically absorbed by working asset investment.*

Investing in Fixed Assets

Cash is also required to invest in FIXED ASSETS as required. The need for investment is determined largely by the nature of competition in the markets in which the business operates. In a competitive market, changes in consumer expectations and technology will constantly drive suppliers to design better and cheaper products to satisfy consumer needs, the fixed asset investment needed to do this must then be committed before production can take place. Depending on the nature of the fixed assets acquired, it may be possible to borrow much of the funds required to finance acquisition or construction.

Timing is also important when investing in fixed assets. Invest too early and you may not achieve sufficient utilisation to recover your investment, invest too late and your competitors may have already captured markets and reduced operating costs ahead of you.

HOW DOES ANY BUSINESS GENERATE CASH?

In order to generate cash the business must go round the WORKING ASSET CYCLE at least once. Every time the business completes a circuit more cash is generated. It follows from this that it makes sense to get very good at going round the working asset cycle very quickly as this will generate more and more surplus cash! This is what good businesses seek to optimise. Delays in completing a circuit can wipe out the extra cash simply due to the cost of financing the working asset investment. If you can regularly make a circuit round the WORKING ASSET CYCLE faster than your competitors you have a competitive advantage.

What Causes Businesses to Fail?

There is only one answer to this question. *It is because they have run out of cash*.

In a crisis all the boxes in the model become temporary or short term sources of cash, fixed assets can be sold, inventory reduced, creditors increased, overheads reduced, and so on. However, there is a natural limit to this process, there comes a point where the assets left in the business and overheads remaining are those without which it cannot continue to trade. As the business is distressed equity providers and lenders are no longer interested in supporting the business. At this point the business has run out of sources of cash.

More specifically, businesses fail because two adverse events take place simultaneously. A creditor demands payment in respect of a liability and the business does not have the cash available to pay as is demanded. As a result the creditor successfully forces the business into bankruptcy.

The rules regarding the actions to take when a business becomes insolvent vary depending on the location of the business. In countries with Roman law legal

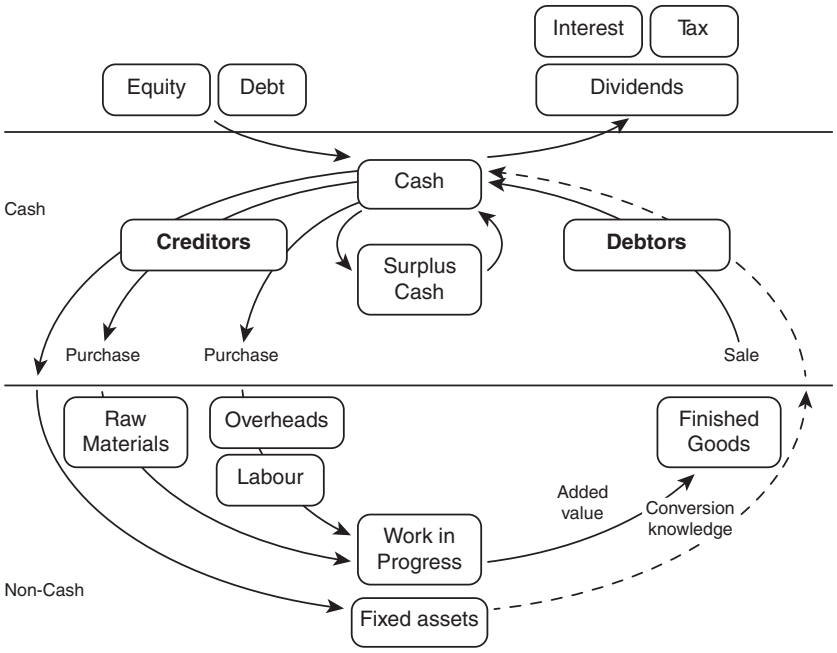

Figure 1.8 Diagram seven of the cash flows of a manufacturing business

systems the directors may be obliged to apply for court supervision and direction when the business becomes insolvent.

In Anglo-Saxon law countries it is usually an offence to trade whilst knowingly insolvent. However, exactly what constitutes this condition is not tightly specified. So, if there is no creditor who has any interest in forcing the business into bankruptcy it is unlikely to happen, irrespective of the state of the balance sheet or the availability of liquidity.

Remember the only sustainable (and most important) source of cash generation is the cash generated from operating the business (for which I use the term the OPERATING CASH MARGIN), which is the extra cash generated each time the business goes round the inner circle in the model (which I have labelled the WORKING CAPITAL CYCLE). This is shown in Fig. 1.8.

THE COMPLETE REAL BUSINESS MODEL

Our model is now almost complete. We see the WORKING CAPITAL CYCLE, we see cash spent on FIXED ASSETS and we see the sources of the cash invested in the business, these being labelled EQUITY and DEBT in the model.

For the purposes of this model and any further discussion in this book, DEBT represents all forms of borrowing, such as loans, mortgages, commercial paper, bonds, lease finance, hire purchase, factoring, invoice discounting and any other form of external debt financing. Basically, if the company pays interest in some form or other in exchange for the loan of the cash, the liability that results is a debt liability.

Any cash surpluses generated that are not paid out are retained in the business as SURPLUS CASH. When this is added to the model the model is complete. This represents an accurate and comprehensive representation of all the significant cash flows of a single business entity. The descriptions on the left-hand side of the diagram refer to the nature of the items shown in the model. Debtors, creditors and cash are items generally denominated as cash values. The non-cash items, inventory, overheads, labour and fixed assets all represent real as opposed to monetary items.

SUMMARY OF THE CHAPTER

Running a business is all about cash. More specifically it is about generating as much cash as possible from going round the working capital cycle again and again. The primary objective is to receive more cash when we sell goods or services than we paid out in fixed asset investment, overheads, labour and raw materials to make or create them.

Businesses *receive cash* from the following sources:

- From successful trading (this being the OPERATING CASH MARGIN)
- From owners in the form of EQUITY
- From lenders and other cash providers in the form of DEBT
- In certain businesses (such a supermarkets) from the WORKING CAPITAL CYCLE itself

Businesses *spend cash* in the following ways.

Within the trading cycle of the business to pay for:

- RAW MATERIALS, LABOUR and OVERHEADS
- Investing in the WORKING ASSET CYCLE
- Investing in FIXED ASSETS

They also make payments to external finance providers and the government in the form of:

- INTEREST
- DIVIDENDS
- TAXATION

- Debt repayment
- Equity buy backs and redemptions

Any cash held but not invested in the operations of the business is defined as SURPLUS CASH. This cash may be the accumulation of historic surpluses or be debt and equity not yet invested in the business itself. It may be retained in order to display that the business has adequate liquidity to operate in the future and to reinforce its credibility as a reliable counter-party.

CONCLUSION

Irrespective of the level of your prior knowledge you should now have an understanding of the way a business operates from a cash flow centric point of view. You should also now appreciate some of the fundamental logic that underpins business operation. The purpose of this chapter is to provide an adequate grasp of the fundamentals of business, and more specifically cash flow, to assist in the assimilation of the more advanced material that follows.