


Chapter 5, Module 7

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Chapter 5 Module 7

AMIS 211
Introduction to Financial Accounting

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 **FISHER**
COLLEGE OF BUSINESS

Hi everyone. Welcome back.

Now that we have gone through a couple of examples of Cash Flow Statements: we have seen how to prepare them; we have seen the different categories of cash flows; and examples of what goes into each category; let's spend a couple of moments and let's talk about how to analyze it.

How might a Creditor or an Investor look at a Cash Flow Statement and make decisions? What sorts of information is the Cash Flow Statement providing to these Investors and Creditors?

And, let's go ahead and jump right into this.

And, go to the next slide.

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Chapter 5 Module 7: Statement of Cash Flows

CASH FLOW ANALYSIS

- 1. The firm should have positive cash flow provided by operating activities. The operating activities are the operations of the company. If there is a negative cash flow here, then it is costing the company more money to operate the business than they are bringing in – not a good thing.**

A net negative cash flow from operations would indicate the company had a net loss using the cash basis of accounting (meaning they spent more cash on operations than they generated from their operations).

And, one of the first things that you should look for if you are analyzing a company's Cash Flow Statement is to look at their Operating Activities. And: Is their Net Cash from Operations a positive or negative number?

For a healthy company, Operating Activities should be a net positive number. You should have Net Cash Provided—not Used—from Operations.

Now, remember what Operations are:

These Operating Activities tell us the Net Income the company would report if they were using the Cash Basis of Accounting.

Basically, it is the Cash that comes in from our Operations minus (-) the Cash that goes out related to our Business Operations.

If Operating Activities are net negative; that is a really bad sign. Because: that is telling us we are spending more money to run the company than what the company is bringing in from its Operations.

So, one thing you always want to look for—probably the most important thing—is that the cash flows from Operating Activities should have a net positive number. You should have Net Cash Provided from Operations. That is the sign of a financially healthy company.

One that is not healthy will most likely have Net Cash Used —not Provided — from Operating Activities.

That is very important.

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CASH FLOW ANALYSIS (cont.):

- 2. The company should have a negative cash flow (i.e., cash used) from investing activities. A negative cash flow here indicates the company is re-investing in itself in order to grow and expand. A positive cash flow here would indicate the company is selling off its long-term assets which is not a good sign for financial health.**
- 3. The cash flows from financing activities can be either a positive net cash flow or a negative net cash flow.**

And, let's talk about the Investing Activities.

Our Investing Activities—this is the exact opposite of Operating—should have net negative cash flow. That is: they should have Net Cash Used from that category.

To have Net Cash Used from Investing Activities means that: you are going out and you are spending cash to buy more equipment, or you are spending cash to buy more machinery, or to make investments.

That is what we want to be able to do. We want to be able to buy this stuff so we can grow the company.

If you show a net positive cash flow from Investing Activities; that means you are selling that stuff off. That means we have sold off some of the equipment, or sold off some of our buildings, or sold off some of our investments, in order to generate cash. And, that is never a good sign.

Hey, yeah, that stuff does happen. Every once in a while we do sell some equipment. You buy new and sell old. That is fine.

But what you do not want to see is the overall Investing Activities category being net positive. That means that you are selling off more than you are investing in. And, that is also a sign of poor financial health.

So, for healthy companies, you are looking for Operating Activities to be Net Cash Provided (i.e., net positive); and for Investing Activities to be Net Cash Used (i.e., net negative).

Now, the third category—the Financing Activities—really does not have sort of that rule of thumb. The Financing Activities can be either net negative or net positive and we really cannot read a whole lot into either/or.

So, if it is net negative or net positive, that is not any indication of either good or poor financial health.

The two areas you are really looking for:

The Operating ones should be Net Cash Provided and the Investing ones should be Net Cash Used.

Those concepts; they are pretty important. You will want to make sure you are comfortable with those.

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Chapter 5 Module 7: Statement of Cash Flows

Assessing Liquidity Using Cash Flows

Rather than using numbers solely from the balance sheet for assessment purposes, we will use numbers from the statement of cash flows and from balance sheets at several points in time.

The ratios are cash-based instead
of accrual-based.

And, let's also talk a little bit about using cash flow numbers to assess liquidity.

Now, what we are going to try to do here is: instead of using numbers from a, say, year-end Balance Sheet; we are going to try to use numbers from both the Cash Flow Statement as well as Balance Sheet information at several different points in time to measure the company's liquidity.

Now, it is important to note with these ratios—or with this one ratio that we are going to deal with—we are going to be based more on the Cash Basis rather than Accrual-Basis numbers.

We are going to try to take numbers out of the Cash Flow Statement and use it as measures of liquidity rather than using just information from the Balance Sheet.

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Liquidity is the ability of a business to pay its debts as they come due.

- ▶ **One measure of liquidity is the current ratio.**
 - A disadvantage of the current ratio is that it uses year-end balances of current assets and current liabilities (may not be representative of a company's position during most of the year.)

And, let's kind-of review a little bit.

Remember what liquidity is:

Liquidity measures the company's ability to pay its debts as they come due.

Now, we talked in a previous chapter about two measures of liquidity: Working Capital; and probably the most common measure—the other one that we talked about—the Current Ratio.

And, the Current Ratio does have a kind-of a problem—it has a bit of a disadvantage—and, that is: the Current Ratio makes use of Current Assets and Current Liabilities at one point in time—typically, the end of year.

However, using just the year-end Current Assets and Current Liabilities might skew the ratio a little bit. Because: the year-end Current Assets or year-end Current Liabilities may not really be indicative of what the company's position was during the year in terms of Current Assets and Current Liabilities.

So, it may give a somewhat skewed picture as to the company's liquidity.

So, we are going to try to eliminate that. We are going to try to bring in some cash numbers to try to minimize, or eliminate, that problem.

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Chapter 5 Module 7: Statement of Cash Flows

Current Cash Debt Coverage Ratio

- A ratio that partially corrects this problem with the current ratio is the current cash debt coverage ratio.

$$\frac{\text{Net cash flow provided by operating activities}}{\text{Average current liabilities}}$$

- Average current liabilities are equal to:

$$\frac{\text{Current liabilities at Jan. 1} + \text{Current liabilities at Dec. 31}}{2}$$

And the ratio we want to talk about is called the Current Cash Debt Coverage Ratio.

The Current Cash Debt Coverage Ratio—And, this Ratio attempts to correct the problem that we just mentioned with the Current Ratio by using numbers both from the Cash Flow Statement as well as from several different points in time from the Balance Sheet.

To calculate the Current Cash Debt Coverage Ratio:

Take the Net Cash Provided by Operating Activities—that one piece of the Cash Flow Statement.

Net Cash Provided by Operating Activities divided by (/) what we are calling the Average Current Liabilities.

We can calculate this Average Current Liabilities by taking the Liabilities at the beginning of the year (January 1st) plus (+) the Current Liabilities at the end of the year (December 31st); and, getting an average by dividing by (/) 2.

This mitigates, or minimizes, the fact that we would just be pulling Current Liabilities from one point in time; by getting an average of where we were from the beginning to the end of the year, it is a much better picture as to what the company's true ability to pay its debts during the year was.

Current Cash Debt Coverage Ratio:

Net Cash Provided by Operating Activities divided by (/) Average Current Liabilities.

And, you can see there how to calculate the Average Current Liabilities.

It is going to tell us the same thing as the Current Ratio—the ability of the company to pay its debts as they come due.

But, hopefully, it is a refinement in that we are using numbers that give us a more accurate picture of the company's ability to do that.

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Current Cash Debt Coverage Ratio

- Since cash from operations involves the entire year rather than a balance at one point in time, it is often considered a better representation of liquidity on the average day.
- One disadvantage to this (and all other) cash-based measures is no readily available published industry averages for comparison

And, kind-of what I just said, a big advantage of the Current Cash Debt Coverage Ratio:

We use the information at the beginning and the end of the year, so we are not hinging our entire ratio at one point in time.

And, we are using some information from the Cash Flow Statement: Cash from Operations. What could be more liquid than that?

However, we do have a problem with this.

The big disadvantage with this Ratio is there usually are not preprinted or established industry averages for these Ratios using Cash Flow numbers. So, it is real hard to find something to compare it to.

And, remember, we said that is awfully important: the Ratios by themselves are rather meaningless unless you have some point of comparison such as an industry average or a competitor.

So, while these Cash Ratios, such as the Current Cash Debt Coverage Ratio, may give us a, perhaps, more accurate picture of the company's liquidity; they are still not frequently used because of the lack of benchmarks or comparison points.