Chapter 4

Cash flow statements

Introduction

If you have followed the plot so far, you should be able to produce a simple income statement and balance sheet for a company. In so doing you have learned something of the principles of accounting and in particular the way in which revenues and costs are 'recognised' in a given period of account. In this chapter you will learn how to produce a cash flow statement.

Cash flow statements are regarded as the most reliable representations of a company's activities during a year. Unlike the income statement, they do not depend upon recognition principles in the measurement of revenue or costs: they record the cash received by a business and the cash paid out under a series of headings. Unless the company is acting fraudulently the cash flow statement should clearly show how much cash has been received and spent by the business. However, they do have their flaws. Cash flow statements do not show the flow of value in the form of commitments made (accounts receivable and payable, prepayments, deferred income and accrued revenues and costs). However, cash flow statements can provide a useful check on the integrity of the income statement.

In this short chapter, our task is to show how to produce a cash flow statement and how to interpret its significance as a check on the validity of the income statement produced with it. To achieve this learning goal we must imagine ourselves forward some years to a point where Sid is a multimillion pound business. This happy situation came about because of a chance encounter with Martin Pickle, the head of the Go All the Way Travel Group, who suggested he should get into the discount airline business. As a result Sid founded Sid's Squeezy Jet and much to the amazement of the long-suffering Beryl it took off.

Learning objectives

There are five outcomes you should achieve in this chapter. Split into three learning sections, their outcomes are as follows:

The measurement of cash flow

- That you can distinguish between the two different value flows in a business and how they relate.
- That you can identify the principal sources of a firm's cash flow.

The techniques of producing a cash flow statement

- That you can classify cash movements within a business into their principal headings within a cash flow statement and then produce a simple cash flow statement.
- That you can produce a cash flow statement from the income statement and balance sheet using the 'indirect' method.

Testing the income statement

- That you can make a comparison between the operating cash flow and operating profit for a business.

The measurement of cash flow[1]

Two financial flows dominate any business: the first and most important is its cash flow. The cash generation and expenditure of the firm determine the short-term success and the long-term survival of the business. The second flow is where revenues are recognised as chargeable to the year in question and accounting costs are matched to the process of earning that revenue and then allocated to different categories of account. These two flows, in so far as they impact upon the financial reports of the business, are shown in Exhibit 4.1.

These two flows have broad similarities but also some crucial differences, and it is easy to become confused between the two. The cash flow of the firm is reasonably straightforward: as operations generate surplus cash (the operating cash flow), interest and tax payments will be made and the remainder is free cash flow to equity (FCFE) before reinvestment. From that FCFE dividends are paid to investors and the balance retained for further reinvestment. From the analytical point of view, greater reliability can be placed upon the cash flow statement than the profit and loss account. It is difficult, but not impossible, to manipulate the reporting of cash flow figures. We will have a look at that scurrilous tendency later in this chapter.

The 'accounting' flow represents the creation of shareholder surplus over time which is accumulated in the owner's equity account. The closest analogue to operating cash flow within the income statement is EBITDA – earnings before interest, tax, depreciation and amortisation. This number is very important for reasons we will discuss later, but it is not reported: we have to calculate it directly from the income statement.

As we have described in earlier chapters, financial accountants employ various recognition rules for revenues and costs before arriving at EBITDA but there should, at steady state, be approximate parity between EBITDA and operating cash flow. Why this should be takes a moment's thought. If a firm's sales are constant and opening receivables, payables and accruals are likewise constant then the opening adjustments in measuring the profit of the business should be the same as the closing adjustments. As a result the firm's profit from its operations, but before it makes the large non-cash deductions for the use of its non-current assets in the form of depreciation and amortisation, should be the same as the net cash flow from its operation.

[1]This section is an edited version of material presented in Bob Ryan's (2005) *Corporate Finance and Valuation,* Cengage Learning, Chapter 10.