

# Cash Flow Statements: The importance of cash from operating activities – Investment Basics XXIX

## 1 OBJECTIVE

The objective of the Cash Flow Statement is to provide users of financial statements with details of cash generated or utilized by operations, investing activities and financing activities. The traditional income statement and balance sheet provide limited information regarding the timing and extent of cash flows of an enterprise. Cash flow statements therefore enable users to form a better assessment of the cash performance.

The cash flow from operating activities is usually considered the most important type of cash flow. A company which consistently fails to generate positive cash from operating activities is likely to land up in financial difficulties. In the long term a satisfactory return on assets, a healthy capital structure, high dividends and hopefully a reasonable rating in the market result from a positive cash flow from operating activities.

## 2 FORMAT

The format of a cash flow statement is usually as follows:

### 2.1 Cash from operating activities

- Cash generated by operations i.e. operating profit before interest paid and taxation, but after adjustments for non-cash items and non-cash components of working capital items
- Cash effects of finance costs and taxation
- Cash effects of distribution to owners

### 2.2 Cash effects from investing activities (i.e. fixed and other assets acquired and/or sold)

### 2.3 Cash effects from financing activities (i.e. issuing of ordinary share capital, preference share capital movements, long-term borrowings and short-term borrowings raised and repaid).

## 3 EXPLANATION OF CASH GENERATED BY OPERATIONS

Cash generated by operations is recorded by adjusting operating income before taxation (as per income statement) by items not involving cash outlay (non-cash items) and by the non-cash components of working capital.

Cash generated by operations is normally strongly positive in relation to operating income. The main source of non-cash items is depreciation which is added to operating income. Increases in non-cash components of working capital (stock plus debtors less creditors) will be a reduction of operating income and decreases of non-cash components of working capital will be added to operating income.

The increase in working capital is a function of increased scale of operations (e.g. sales growth) and slacker control of stocks and debtors and creditors demanding quicker payments. Therefore a change in working capital is a function of growth in sales and the cash conversion cycle (where the cash conversion cycle is equal to the stock period plus the debtors period less the creditors period). A high sales growth rate, although it will generate higher income, could be dangerous if the company has a long cash conversion cycle, especially if the profitability margin is relatively low.

## 4 EXAMPLE

A South African example in the Furniture and Household sector of the JSE of high sales growth rates initially yielding excellent income results and eventually poor results due to the excessive sales growth will be discussed forthwith (see Annexures 1 and 2). The cash flow data is summarised in Annexure 2 and additional non-cash flow data is summarised in Annexure 1.

### ANNEXURE 1 ADDITIONAL DATA

	1988 R'000	1989 R'000	1990 R'000	1991 R'000	1992 R'000
Sales	729 571	934 052	1 287 052	1 409 189	1 422 727
Sales growth		28,03%	37,79%	9,49%	0,96%
Available for equity (per income statement)	43 143	60 129	92 878	(79 224)	(77 120)
Share price at year-end	720	800	1 250	1 100	40
Share price at year-end plus 3 months	750	1 300	1 300	550	12
EPS	260	363	560	(455)	(443)

According to Annexure 1 sales increased from R730m, in 1988 to R1 423m in 1992. The sales growth for 1989/88 was 28%, 38% for 1990/89 and 9% in 1991/90. The amount available for equity (as per income statement) increased from R43m in 1988 to R93m in 1990 only to drop to deficits of R79m and R77m in 1991 and 1992 respectively. EPS naturally showed the same trend. Share prices at year-end (June) and year-end plus three months (September) indicate a peak in 1990 and a sharp drop between 1991 and 1992.

Annexure 2 is constructed as follows:

Operating activities (Line G)

Investing activities (Line H)  
Financing activities (Lines J to M)  
Operating activities (line G) contain four items:  
Cash generated by operations (Line A)  
Working capital (Line B)  
Finance cost and taxation (Line D)  
Dividends paid (Line F)

Subtotals are calculated as follows:

Cash generated by operating activities (C = A - B)  
Cash available from operating activities (E = C - D)  
Cash retained from operating activities (G = E - F)  
Cash flow after investing activities (I = G - H)

**ANNEXURE 2  
CASH FLOW STATEMENT**

LINE	1988 R'000	1989 R'000	1990 R'000	1991 R'000	1992 R'000
<b>Operating activities:</b>					
Cash generated by operations	63 850	89 929	150 282	132 792	(130 189)
Working capital	(83 952)	(84 604)	(241 945)	(183 071)	197 770
Cash generated by operating activities	(20 102)	5 325	(91 663)	(50 279)	67 581
Finance cost and taxation	(14 342)	(20 862)	(40 985)	(77 993)	(86 987)
Cash available from operating activities	(34 444)	(15 537)	(132 648)	(128 272)	(19 406)
Dividends paid	(4 145)	(17 916)	(43 723)	(30 806)	(3 738)
Cash retained from operating activities	(38 589)	(33 453)	(176 371)	(159 078)	(23 144)
<b>Investing activities</b>					
Cash flow after investing activities	5 169	(8 763)	(58 719)	(600)	(26 559)
<b>Financing activities:</b>					
Ordinary shares	26 915				
Preference shares		58 500	104 270	(3 890)	(5 101)
Long-term loans	577	(11 029)	129 355	163 568	246 349
Short-term loans	5 928	(5 255)	1 465		(191 545)
	0	0	0	0	0

The signs of the subtotals are very important. Negative cash flows are given in brackets. It is of the utmost importance that lines C and E show a positive cash flow in the long term. In the example under discussion line E is negative throughout the period and line C has three negative cash flows (eg. 1988, 1990 and 1991).

Cash generated by operations (line A) is positive throughout, except for 1992 with a negative R130m. With the exception of 1992, when sales growth (Annexure 1) slowed down, and 1989 cash generated by operating activities (line C) remained negative. Due to relatively high finance costs and taxation (line D), cash available from operating activities (line E) remains negative throughout the period with a peak of R133m in 1990.

Notwithstanding the negative line E, the company paid out dividends (line F) resulting in negative cash retained from operating activities (line G). It would appear from Annexure 1 that they did not have the cash income to pay such dividends and had to borrow to finance the payment of dividends.

Due to the pressure of investing activities (line H), the company had to rely heavily on financing activities. Ordinary shares were only issued in 1988 (line J). Heavy use was made in 1989 and 1990 of preference shares (line K) and long-term loans in 1990 to 1991 (line L). The results of the above were that finance cost (part of line D) and dividends on preference shares (part of line F) increased to a very large extent and probably contributed to the large loss in 1992 and eventual delisting in 1993.

If the annual sales growth rates are considered, relatively large growth rates of 28% and 38% were experienced in 1989 and 1990 resulting in large amounts to be invested in working cap-

ital 1989 to 1991 (line B). Although net income, EPS and amount available for equity per income statement increased considerably from 1988 to 1990, the opposite trend is observed if line E is studied. Differences between traditional accrual accounting (see entry: Available for equity as per Annexure 1) and cash flow accounting (line E) is especially obvious in 1990 when the highest sales growth occurred.

## 5 CONCLUSION

Had the company slowed down the sales growth rates in 1989 and 1990, additional working capital required would have been much smaller. As stated above, line B is a function of sales growth and the cash conversion cycle. Due to the nature of the industry, the company's average cash conversion cycle over the period 1988 to 1992 was 163 days or close to 5 months.

Lower sales would have resulted in a lower line A, but the drop in line A would have been compensated by a reduced increase in working capital (line B). As a result, line C could perhaps have been much less negative in 1990. A smaller deficit in line C in 1990 could have also resulted in lower finance costs (part of line D). The overall impact of a lower sales growth in 1990 could have resulted in a large reduction of the need to issue preference shares and long-term loans in 1990. The reduced preference shares and long-term loans (1990) would have saved finance cost and preference dividends in 1991 and 1992.

With hindsight it is clear that the company's sales growth exceeded its sustainable growth rate. As a result, cash generated by operating activities became negative in 1990 and 1991. A company which consistently fails to generate positive cash from operations is most likely to land up in financial difficulties.