

Cash Flow Fundamentals for Business Professionals

Understanding how cash actually moves through a business is the foundation of sound financial analysis. This course introduces the core concepts behind business cash flow and explains how to interpret cash flow statements accurately. Whether you work with small businesses or large enterprises, you'll build the foundational knowledge needed to distinguish between cash movement and accounting profit—a critical skill for any CPA or financial advisor working with real-world clients.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall various cash flow items of a business.
- Recognize the various sections of a cash flow statement.

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TABLE OF CONTENTS

CHAPTER

01

Understanding How Cash Flows In A Business 4

1.01	Introduction	4
1.02	Figure 1.1 Diagram Of The Cash Flows Of A Simple Trading Business...	7
1.03	Figure 1.3 Diagram Two Of The Cash Flows Of A Manufacturing Business	10
1.04	Figure 1.5 Diagram Four Of The Cash Flows Of A Manufacturing Business	13
1.05	How Does Any Business Generate Cash?	18
1.06	Summary Of The Chapter	21
	Test Your Knowledge.....	23

CHAPTER

02

Understanding Cash Flows Properly 26

2.01	Introduction	26
2.02	Figure 2.1 Diagram Of The Working Asset Cycle	30
2.03	Cash Flows From Investing Activities.....	37
2.04	The Nature Of The Beast – Conclusion	41
2.05	Table 2.4 Unadjusted Cash Flow Section Totals	43
2.06	The State Of Play	52
	Test Your Knowledge.....	53

Final Exam Copy	57
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Index	
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Chapter 1: UNDERSTANDING HOW CASH FLOWS IN A BUSINESS

Chapter Objective

After completing this chapter, you should be able to:

- Recall various cash flow items of 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.

While developing this model based on the cash flows of a business we also introduce some fundamental logic about what different types of businesses 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 traveled 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 recognized 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 maximization for the owners. For the purposes of this course 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 2 of course 21705B.)

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?

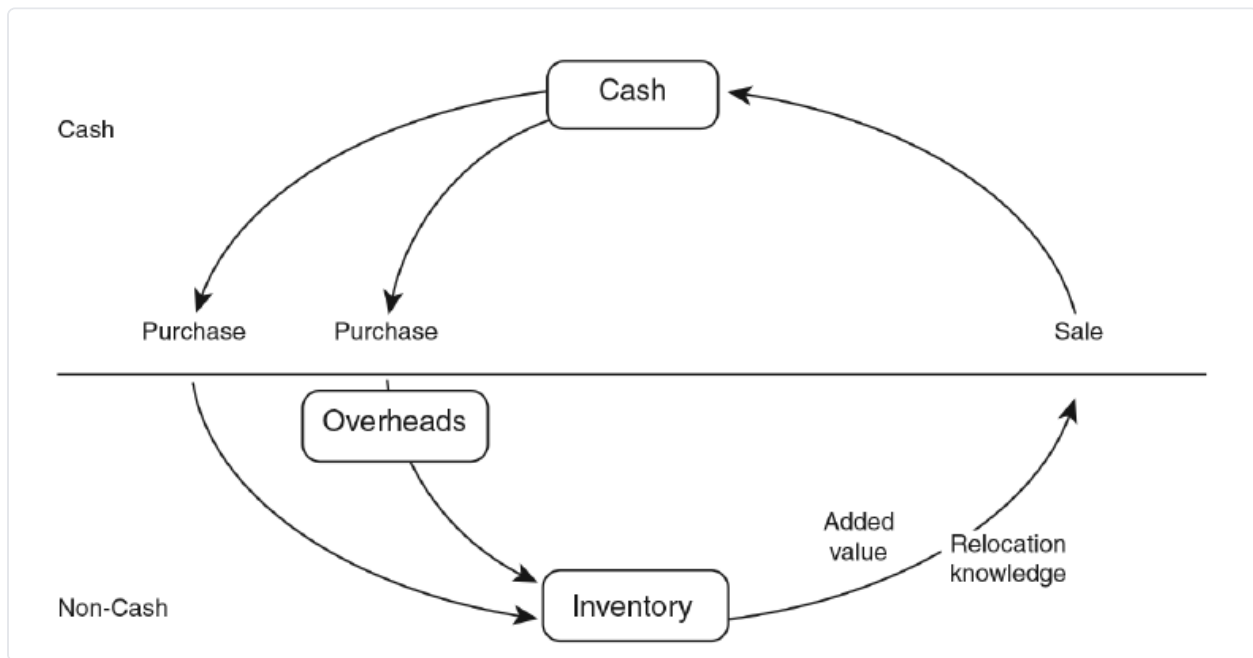
This is unlikely. What most of us do is go to the nearest convenience store, which may be just down the street and buy what we wish to consume for our breakfast. So, what then is the owner of the convenience store doing to add value? What he does is relocate a range of goods he knows we are likely to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

FIGURE 1.1 DIAGRAM OF THE CASH FLOWS OF A SIMPLE TRADING BUSINESS



Using CASH the trader makes purchases of goods, which he holds as INVENTORY. Sometime 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.

THE SIMPLE MANUFACTURING BUSINESS

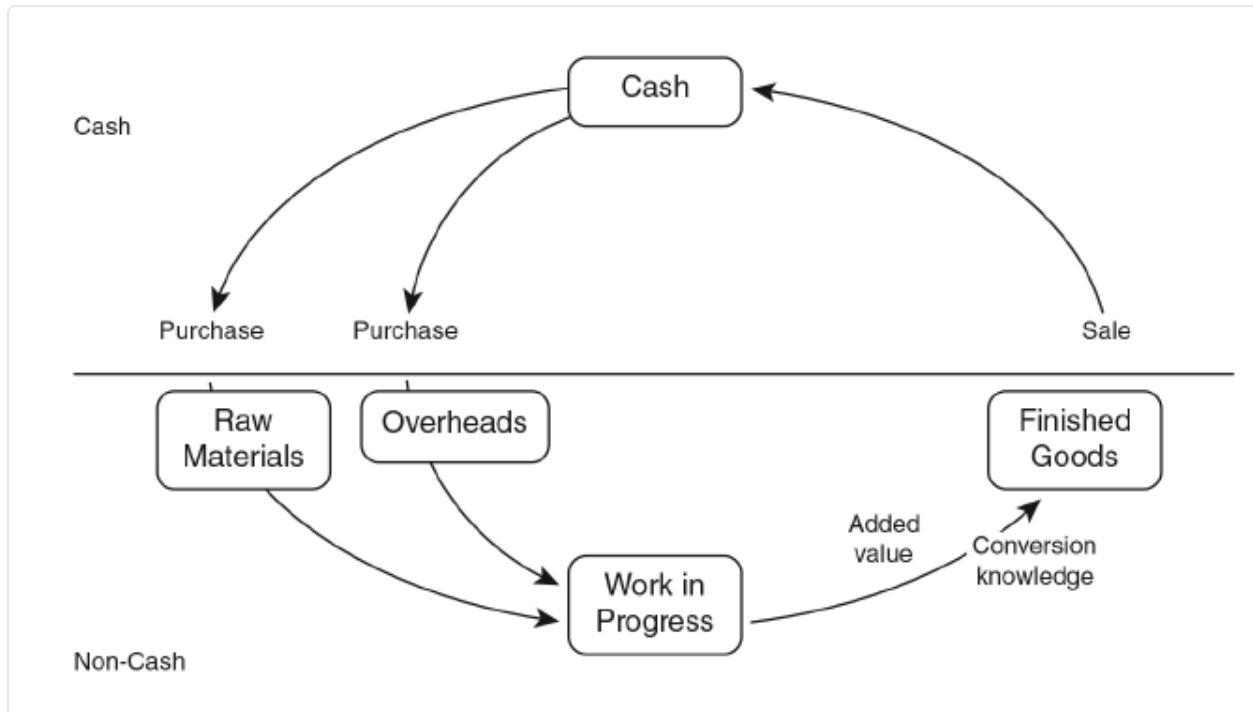
In my other life as a financial trainer I have traveled all over the world offering training seminars on financial analysis and related subjects. One of the places I have visited on my travels is Nairobi in Kenya. When traveling from Nairobi airport to the training location I noticed business people 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 analyzing 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.

FIGURE 1.2 DIAGRAM ONE OF THE CASH FLOWS OF A MANUFACTURING BUSINESS

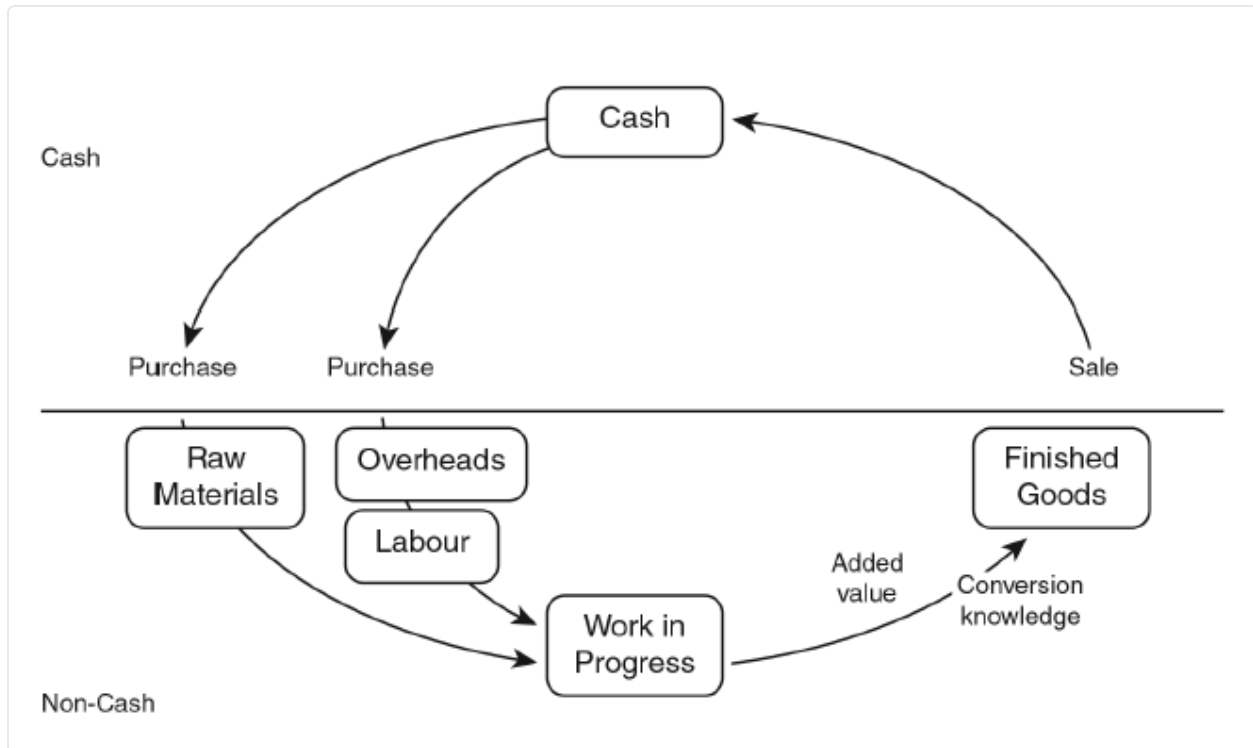
Using CASH the manufacturer makes a purchase of RAW MATERIALS and does work on them, so converting them to WORK IN PROGRESS and eventually FINISHED GOODS. These items being akin to INVENTORY in our previous model. Some time later he resells the finished goods for more than the cash costs of producing them, receiving cash in exchange for the items. He will typically 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 labor to the business to increase output and hence cash flow. This is because there is much labor available and, given the emerging market location of the business, this labor is available relatively cheaply (Fig. 1.3).

FIGURE 1.3 DIAGRAM TWO OF THE CASH FLOWS OF A MANUFACTURING BUSINESS

Labor 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 labor costs are significantly higher per hour and employees are protected in many ways by a mass of social legislation 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 labor 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 labor (Fig. 1.4).

FIGURE 1.4 DIAGRAM THREE OF THE CASH FLOWS OF A MANUFACTURING BUSINESS

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 labor or purchase fixed assets would be things like, the law and regulations affecting the cost and flexibility of labor, the local environment governing labor and investment in fixed assets, and the availability and quality of labor.