

Business Life Cycles and Cash Flow Restatement

Every business moves through distinct life cycle stages—start-up, growth, maturity, and decline—and each stage produces a unique cash flow profile. This course explores how those stages shape a company's financial position and walks you through the process of restating cash flows for a real business. If you analyze financial statements for clients at any stage of business development, this course gives you practical tools to assess what the numbers are really telling you.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 9

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 9 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

- Identify characteristics of businesses in the four different life-cycle stages for businesses.
- Recognize the most common method in preparing cash flow statements.

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Chapter 1: START-UP, GROWTH, MATURE, DECLINE

Chapter Objective

After completing this chapter, you should be able to:

- Identify characteristics of businesses in the four different life-cycle stages for businesses.

INTRODUCTION

In order to gain further benefit and insight from the results of our cash flow restatement we need to understand what a typical set of “good” cash flows should look like.

The typical “good” pattern of cash flows varies dramatically between different businesses. The most important reason for this variety is to do with where the business is in its life cycle.

In this section we look at the typical cash flows of a business at start-up, in the growth phase, the mature phase, and finally the decline phase. To make this section as useful as possible to the analyst I have included a short discussion of exactly what we mean by the terms start-up, growth, maturity and decline when applied to business analysis.

Later in the course there are separate chapters on each of the four phases. They go into more detail about various aspects of analysis relevant to that particular phase. All cash flow values quoted in the text from the examples represent thousands.

THE START-UP PHASE

When does business commence?

As any entrepreneur knows, there are a number of steps that precede the commencement of trade.

Most entrepreneurs start with an idea for a new product or service. They then research the viability of the idea, the initiatives required, assess the feasibility of operations, the business risks involved and develop a business plan. This part of the process can take years. Assuming the viability of the project looks good, the entrepreneur at some point raises capital and invests in the necessary initiatives to develop the product or service.

At some point, once operations are established on a commercial scale, sales commence to customers of the business. This is when the first cash inflows from operations arrive. Prior to this point we do not have a true business. You could say we have a charity! Some person or persons (the project sponsors) are giving money to other persons to do things for them.

Why is this issue of what constitutes a true business so significant?

In the past I have observed numerous situations where entrepreneurs and businessman have claimed to be running a business, but in fact there is no true business there. There may be products, factories, employees, sales literature and administration. What's missing is sales and hence cash flow from customers! In other words demand for the product or service provided has not yet been proven to exist.

I recollect visiting a start-up business that had developed a new form of solar heating device. I was shown a completed version of the product, met employees and was shown a factory containing various machinery purchased to manufacture the product. However, at this point, there was no sales activity at all! The business closed having run out of cash before any material level of sales had been achieved.

So, for the purposes of analyzing cash flows, my definition of "a start-up business" is the achievement of regular operating cash flow from customers. The business may not be proven to be viable in the long run at this point; however, some important milestones will have been passed.

1. The product or service is being delivered successfully.
2. Someone, somewhere (a customer) is willing to pay for it.
3. Customers are continuing to consume the product or service after their first purchase (there are repeat purchases).

The business will almost certainly still be cash negative and loss making at this point. The long journey to success is not yet complete. However, the basic credibility of the business model has been demonstrated. In the later chapter on the start-up phase we will discuss in more detail what happens in the period before this point.

So, in this initial example, my start-up business has already designed the first product or service to be sold and invested sufficiently to deliver this. Customers are starting to buy the product.

The cash flows of a start-up business could look like the example in Table 3.1.

TABLE 3.1 THE CASH FLOWS OF A START-UP BUSINESS

Start-up example	Dollars
Restated Cash flows year 1	'000
OPERATING CASH MARGIN	-10
(INVESTED)/GENERATED FROM NET WORKING ASSETS	-200
NET CAPITAL EXPENDITURE	-500
TAXATION	0
CASH AVAILABLE TO SATISFY FINANCE PROVIDERS	-710
NET INTEREST	30
NET DIVIDENDS	0
OTHER NON-OPERATING INCOME/(EXPENDITURE)	300
NET CASH GENERATED/(ABSORBED) BEFORE FINANCING	-380

Financed by:

INCREASE/(DECREASE) IN EQUITY	500
INCREASE/(DECREASE) IN DEBT	0
(INCREASE)/DECREASE IN CASH	-120
TOTAL CHANGE IN FINANCING	380

Let us assume that an entrepreneur has recently started a new business. The business is manufacturing some sort of consumer product that requires an investment in machinery.

The restated cash flow summary reports the cash flows over the first year of operation. Let us review what the template tells us about the business.

The operating cash margin is negative as the business is still producing goods for more cash cost than they receive in sales income. This is because the volume through the plant is still too low to capture the necessary economies of scale to be profitable. The workforce is still learning to manufacture the product to the required levels of quality in an efficient manner. Production is not yet particularly efficient.

The business is investing in the net working assets it requires. The business has to invest in inventory; it must have sufficient raw materials, work in progress and finished goods to be able to satisfy customer needs as required. In addition it will be obliged to provide trade credit to its customers (invest in debtors) as it acquires them if this is normal practice in the market in which the business operates. It will enjoy little if any trade credit from its suppliers, however, due to the newness of the business and lack of track record on which the suppliers could base a credit assessment. Most raw material purchases will be in cash.

The business is investing in fixed assets. In this year the entrepreneur has purchased the first machine required to commence production as well as other fixed assets needed to package and distribute the product.

The business pays no taxes at this point, as it has never made a profit. Indeed there is likely to be a tax loss carried forward at the end of the year.

The cash available to satisfy finance providers is a substantial negative. This is typically what we expect to see at this point in the start-up businesses development.

The business has a small amount of interest received due to having a net cash position in its balance sheet. There is no interest payable as the business has no debt at this point in its development.

The business does not pay a dividend at this point because any cash available at this point is used for investment and because it's probably illegal! In many countries dividends can only be paid out of positive revenue reserves. At this point the revenue reserves of the business are negative in the balance sheet.

The business receives a substantial grant from the government because it is creating employment in its location. The entrepreneur has employed five persons on start-up.

The net cash absorbed before financing at the end of the first year's trading is \$380. This is financed by the introduction of \$500 in equity from the entrepreneur, her family and other investors. At the end of the period \$120 of this new equity remains in the business cash account unspent.

This is a typical set of start-up cash flows. Generally the business is cash negative, the shortfall being financed by investors.

THE GROWTH PHASE

The next three most important objectives are to achieve a positive cash flow position, to break even and to make this sustainable into the future. Ideally these objectives are achieved in the first two to three years of the life of the business. The business then enters the growth phase.

What exactly do we mean by a growth business? We mean a business whose VOLUME of output (or if it is a service business, its scale of operations) is growing. Inevitably this requires investment in both working assets and fixed assets (Table 3.2).

TABLE 3.2 THE CASH FLOWS OF A GROWTH BUSINESS

Growth example	Dollars
Restated Cash flows year 4	'000
OPERATING CASH MARGIN	1000
(INVESTED)/GENERATED FROM NET WORKING ASSETS	-400
NET CAPITAL EXPENDITURE	-900
TAXATION	-300
CASH AVAILABLE TO SATISFY FINANCE PROVIDERS	-600
NET INTEREST	-100
NET DIVIDENDS	0
OTHER NON-OPERATING INCOME/(EXPENDITURE)	100
NET CASH GENERATED/(ABSORBED) BEFORE FINANCING	-600

Financed by:

INCREASE/(DECREASE) IN EQUITY	300
INCREASE/(DECREASE) IN DEBT	210
(INCREASE)/DECREASE IN CASH	90
TOTAL CHANGE IN FINANCING	600

Let us assume our example manufacturing business has successfully negotiated the start-up phase, the business is now growing strongly. How does this change what we see?

The operating cash margin is now positive and the business is generating a healthy cash surplus against its cash costs every time it sells its product to customers.

The business is still investing in net working assets because it is growing its unit output strongly. It therefore requires investment in increasing its inventory and its debtors. The business is now able to obtain some trade credit from its major suppliers as it is trading profitably and has a three-year track record available for analysis. This offsets some of the investment required in inventory and debtors.

The business is still investing in fixed assets because it is still growing; further machinery is purchased as required to increase output as the business expands. Periodically the factory itself may require expansion.

The business is now paying some taxes; however, the liability is not large. As a consequence of the capital investment there is substantial tax depreciation available to reduce the tax liability.

The cash available to satisfy finance providers is still negative. Again, this is typically what we expect in a growth business. The reason it is negative is that the business is making the fixed and working asset investment required to keep pace with growth in demand for its products faster than it is generating cash from the operating cash margin. The presumption when the investment is made is that the investment in fixed and working assets in the current period will yield more operating cash margin from the resulting increases in the volume of output in future years as the business continues to grow. Investors are prepared to finance this if they believe the future increase in operating cash flow as a result of the investment will be sufficient to recover or exceed the cash they invest in the new fixed and working assets.

The business is now paying interest. In our example, finance leases have been used to acquire some of the machinery and represent part of the capital expenditure. The young business in the growth phase is still too risky for most commercial banks to consider lending medium-term finance. However, leasing companies are less concerned about the business risk issues as they have the security of the machinery (against which they have lent) to rely on should the business cease to make the monthly payments required for any reason.

No dividends are being paid at this time, as the business is still cash negative. All surplus resources are focused on continuing the rapid growth of the business.

The business continues to receive grants from the government in respect of employment creation as it continues to take on more new employees for the first time.

The net cash absorbed before financing at the end of the fourth year's trading is \$600. This is financed by the introduction of \$300 in equity from growth stage investors and the introduction of \$210 of debt being the principal outstanding in respect of the finance leases on new fixed assets. The remaining \$90 required has come from cash and cash equivalents already in the business as the beginning of year four.