

Restating and Analyzing US GAAP Cash Flows

US GAAP cash flow statements don't always present information in the most analytically useful way. This course covers how to restate GAAP-formatted cash flows into a more meaningful structure and then applies that framework to the analysis of mature businesses. Ideal for CPAs and financial professionals who regularly work with audited financial statements and want to move beyond surface-level interpretation to a deeper understanding of a company's true cash-generating ability.

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

- Recall the background and source of a US GAAP cash flow statement.
- Recognize the cash flow issues of mature businesses.

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Chapter 1: RESTATING US GAAP CASH FLOWS

Chapter Objective

After completing this chapter, you should be able to:

- Recall the background and source of a US GAAP cash flow statement.

INTRODUCTION

In the United States all entities subject to the US Securities and Exchange Commission (SEC) control have been required to publish a cash flow statement as part of their statutory disclosure since 1998.

In Chapter 2 of course 21702B we analyzed in detail the cash flow statement of Nokia, a business that has been reporting using IAS GAAP for some years.

Rather than repeating in detail the general issues involved in restating the operating, investing and financing cash flows into the recommended template, in this chapter we will look at the essential points of difference between the IAS GAAP restatement and a US GAAP restatement. This approach will also be used in the following chapters when discussing differences between types of GAAP and IAS.

THE US GAAP CASH FLOW ANALYSIS PROCESS

We have a US GAAP cash flow statement to analyze, how do we go about our task?

Note

There are two possible ways of preparing and presenting a cash flow statement, these are known as the direct method and the indirect method. The first task to ascertain is whether the cash flow is a direct cash flow or an indirect cash flow.

FAS 95 – Statement of cash flows – encourages US companies to use the direct method. Despite this guidance from the standard setters I have yet to come across a US GAAP cash flow statement prepared using the direct method. All the US GAAP cash flow statements I have ever seen were prepared using the indirect method.

Note

A direct cash flow is prepared by taking the cash records of the business, coding each cash transaction during the period into its relevant cash flow constituent and then summarizing the resulting information into a cash flow statement.

We can identify whether a cash flow statement is direct or indirect by examining the first few lines of the cash flow statement. In the case of direct cash flow statements instead of starting with a profit value taken from the profit and loss account the cash flow typically starts with receipts from customers and payments to employees and suppliers.

Note

An indirect cash flow is prepared by identifying the various cash flows required to prepare the cash flow statement from information contained within the profit and loss account and balance sheet of the business. All the US GAAP cash flow statements I have ever analyzed were indirect cash flow statements.

We can now proceed to understanding in detail the restatement process for a US GAAP reporting entity. We will deal with this issue section by section using Black & Decker, the US manufacturer of DIY power tools as an example.

Arithmetic Signage in the Cash Flows

By signage we mean whether a cash flow is positive (an inflow) or negative (an outflow). Generally the treatment of the signage of values contained within a cash flow statement is straightforward. Positive values represent cash inflows and negative values represent cash outflows. All signage should be summarized into the template as observed.

In the template, brackets are used with certain of the labels to signify the meaning of the signage of the cash flow, in the examples brackets or a minus sign may be used to signify negative cash flows.

The only exception to this rule is the last number in the cash flow statement, which is usually the change in cash, or the change in cash and cash equivalents. Unless the published cash flow is laid out as a balancing statement the final cash value shown will require its signage reversing to make the restated cash flow template balance. The reasons for this are explained in Chapter 1 of course 21702B.

Acronyms

From now on we will start to use the following acronyms to describe certain values. The first time the term is used in the text the acronym will normally follow.

EBIT	Earnings before interest and tax
EBITDA	Earnings before interest, tax, depreciation and amortization
P&L	Profit and loss account
IAS	International accounting standard
IFRS	International financial reporting standard
M or m	Million meaning 1 000 000

SOURCES OF CASH FLOW DATA

All filings of businesses listed on US stock markets are available online at www.sec.gov/edgar.shtml.

Domestic US entities file a Form 10-K. Overseas entities file a Form 20-F. These forms are the regulatory equivalents of annual reports, they contain the same information, but in a highly organized regulatory format, with much additional disclosure required by US regulators. Many larger companies also issue a glossy annual report and accounts, which is typically available as a pdf file download from the group's corporate web site.

The Major Differences Between US GAAP Cash Flows and IAS GAAP Cash Flows

Firstly, indirect US GAAP cash flows start with the value *net income or net earnings*. This is the profit value from the P&L that represents the equity providers' earnings. It is the value of profit after interest, tax and minority interests. As a consequence of this we expect to see a significant number of add-backs in the operating cash flow section of the cash flow statement in order to arrive at the OPERATING CASH MARGIN.

Secondly, we do not find the values relating to interest-paid or taxation-paid in the cash flow. As a consequence if we restate all of the numbers in a US GAAP cash flow into the template we have no entries for interest or taxation in the template and the resulting OPERATING CASH MARGIN value at the top of the template is actually the operating cash margin *after interest and taxes*.

The good news is that the values of interest and tax paid are usually disclosed elsewhere in the 10-K Form. In the case of Black & Decker the interest payments are shown in Note 8 to the accounts and the taxation payments are shown in Note 11. Sometimes these values are disclosed in a note referring to cash flows; sometimes they are shown as additional information directly underneath the cash flow statement.

RESTATING THE CASH FLOWS FROM OPERATING ACTIVITIES

The information in Table 5.1 is taken from the form 10-K of Black & Decker for a sample year.

TABLE 5.1 CONSOLIDATED STATEMENT OF CASH FLOWS, THE BLACK & DECKER CORPORATION AND SUBSIDIARIES (MILLIONS OF DOLLARS)

YEAR ENDED DECEMBER 31st OPERATING ACTIVITIES Net earnings \$518.1 Adjustments to reconcile net earnings to cash flow from operating activities of continuing operations: Loss from discontinued operations – Non-cash charges and credits:

Depreciation and amortization	143.4
Stock-based compensation	25.9
Amortization of actuarial losses and prior service costs	25.7
Tax settlement	(153.4)
Restructuring and exit costs	19.0
Other	.5

Changes in selected working capital items (net of effects of businesses acquired or divested):

Trade receivables	99.4
Inventories	(32.0)
Trade accounts payable	32.6
Other current liabilities	33.3
Restructuring spending	(1.0)
Other assets and liabilities	14.4
CASH FLOW FROM OPERATING ACTIVITIES OF CONTINUING OPERATIONS	725.9
CASH FLOW FROM OPERATING ACTIVITIES OF DISCONTINUED OPERATIONS	–
CASH FLOW FROM OPERATING ACTIVITIES	725.9

This is *cash flow from the operating activities* part of the full 10-K cash flow statement.

Generally the cash flow from operating activities section of a published cash flow statement contains values relating to the first two lines of the template. Because of the omission of interest and taxation information from the published cash flow there will be no reference to either value in the cash flow statement itself.

How then do we analyze the cash flows of a US entity reporting under US GAAP?

Our strategy is to first complete Jury's Template without the interest or taxation values inserted and make it balance, so confirming that we have avoided arithmetic errors in our extraction and summarizing of the cash flow statement. In this form the template will be incomplete.

The most important thing to remember is that without the interest and tax values inserted the top line does not represent the operating cash margin, it represents the operating cash margin after interest and tax payments.

TABLE 5.2 BUILDING UP THE TEMPLATE – DEALING WITH THE FIRST TWO LINES

BLACK & DECKER – Summary cash flow template OPERATING CASH MARGIN (after interest and tax payments) (INVESTED)/GENERATED FROM NET WORKING ASSETS NET CAPITAL EXPENDITURE TAXATION CASH AVAILABLE TO SATISFY FINANCE PROVIDERS NET INTEREST NET DIVIDENDS OTHER NON-OPERATING INCOME/(EXPENDITURE) NET CASH GENERATED/(ABSORBED) BEFORE FINANCING Financed by: INCREASE/(DECREASE) IN EQUITY INCREASE/(DECREASE) IN DEBT (INCREASE)/DECREASE IN CASH TOTAL CHANGE IN FINANCING

Once we have summarized all three sections into the template and made it balance we will then add the interest and tax values and adjust the operating cash margin value accordingly. This is an important step that should not be omitted, the reason for this is that it changes the CASH AVAILABLE TO SATISFY FINANCE PROVIDERS to the correct value. Without the interest and tax values inserted this value is incorrect and the template is incomplete.

IDENTIFYING THE OPERATING CASH MARGIN (AFTER INTEREST AND TAX PAYMENTS)

The cash flow statement starts with the value net earnings/(loss). Where does this come from in the profit and loss account (P&L)? The full P&L is shown in Table 5.3, from this it can be seen that it is identical to the net earnings value in the P&L, which is the share of profit “owned” by the equity providers. In US GAAP it is also the value on which the net earnings per common share is calculated.

TABLE 5.3 CONSOLIDATED STATEMENT OF EARNINGS, THE BLACK & DECKER CORPORATION AND SUBSIDIARIES (DOLLARS IN MILLIONS EXCEPT PER SHARE DATA)

YEAR ENDED DECEMBER 31st