

# Advanced Cash Flow Analysis and Performance Applications

Declining businesses, poor cash flow situations, and the tension between cash and profit are all covered in this practical course. You'll explore how to analyze cash flows for businesses in decline, what steps to take when cash flow is problematic, and how to apply cash flow analysis to credit risk and performance measurement. The course also addresses direct cash flow statements, making it a comprehensive resource for CPAs who advise clients across a wide range of financial circumstances.

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

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## LEARNING ASSIGNMENTS AND OBJECTIVES

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### 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

- Recognize the cash flow issues of decline businesses.
- Identify causes for a cash flow shortfall.
- Recognize the differences between cash flow and profits.
- Identify the impact of credit risk in analyzing cash flow statements.
- Identify which financial ratio is best for measuring success.
- Recall how direct cash flow statements are prepared.

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## Chapter 1: ANALYZING THE CASH FLOWS OF DECLINE BUSINESSES

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### *Chapter Objective*

After completing this chapter, you should be able to:

- Recognize the cash flow issues of decline businesses.

In Chapter 1 of course 21702B, I introduced the concept of assessing business cash flows by relating them to the pattern we expect to see for a business in the life cycle of the markets in which it operates. The final part of the business life cycle we need to examine is decline.

I define this as a business operating in a market where demand is falling. It is a consequence of change, which may be technological, environmental, demographic or be related to consumer tastes or fashion, and it occurs at some point in all industries and markets.

I do not mean a business that is being badly managed, although the label decline is also used in general English for this, a business can be badly managed in any of the four phases of its potential life.

Over the past 20 years there have been huge global changes in places where goods are manufactured. I have first-hand experience of the effects of globalization on the footwear and clothing industries in particular, as I have lived in an area seriously affected by these changes for much of my life. In both industries the majority of volume production of product for the mass market in the UK now takes place in other countries.

Many other industries, such as shipbuilding, car manufacturing, electronics and engineering have also faced similar pressures. These changes have come about due to a number of factors which have reduced the economic cost of operating at a distance from consumers. It is a combination of containerization, cheap air travel, global courier services, computerization, the fax machine and subsequently the Internet, and a relatively benign regulatory environment, that has made it cost effective for large producers to supply global markets from a handful of factories situated in economies with a low cost of labor.

Any business in a high labor cost economy where the production process is necessarily labor intensive has been vulnerable to being undercut (that is, competitors selling what you produce at a price you cannot match without losing money) and eventually being pushed out of their traditional markets by similar businesses operating in lower cost economies.

What choices do businesses have when faced by such a situation? Remember that the goal of wealth maximizing businesses is to seek to optimize cash flows at all times, even in decline.

There are both offensive and defensive strategies available for businesses.

Offensive strategies are as follows:

- Relocate production to a low cost location.
- Use technology to gain an offsetting cost advantage for higher labor costs.
- If economies of scale are available at a larger size, acquire other similar businesses to gain sufficient volume to take advantage of them.
- Use the cash flow from declining markets to diversify the business into new markets that require similar core competences to those exploited in the markets being abandoned.
- Use the cash flow from declining markets to diversify the business into completely new markets for the business.

Defensive strategies are as follows:

- Exit now or later by selling the business.
- Exit now or later by winding the business down in an orderly way and realizing the assets.
- If the decline is in its early stages recognize the volume decline as inevitable and manage the business to maintain cash flow whilst reducing operating capacity until it is no longer economic to continue.

Generally, owners and managers seek continuity. Indeed, the nature of capital investment (spend now, get benefits later) means that it is necessary to think and plan in terms of years in order to get a return from the initial investment. So it is unusual to see owners and managers who are content to manage a business in a decline market by accepting the turnover fall until exit is inevitable.

Generally they seek instead to diversify the business away from the decline market into new markets (for the business). They use the cash flows from the existing mature and decline business areas to make their entry into the new market, which may be start-up, growth or mature. Nokia is a good example of this, originally commencing its existence as a paper works in 1865. Nokia Corporation as we know it today was formed from the merger of Nokia Ab, the Finnish Rubber Works and the Finnish Cable works which formally merged in 1967.

## HOW DOES DECLINE AFFECT CASH FLOWS?

One of the consequences of decline is that price competition between the remaining competitors in a market is likely to be intense. This is because each individual business is still trying to maintain or grow its volume output, even though the overall volume consumed by the market is dropping. Due

to overcapacity amongst producers the market is oversupplied with product so allowing customers to seek lower and lower prices by threatening to transfer to other suppliers.

So, we expect to see a steady erosion of the operating cash margin over time, indeed this is a late signal that the business is facing permanent rather than temporary problems in the choice of markets in which it chooses to compete.

Dawson International is a leading supplier of cashmere to the textile industry. Based in Scotland, it operates in three divisions spinning, knitwear and home furnishings. It has been in steady decline for the last decade (Table 10.1).

**TABLE 10.1 EIGHT YEARS SALES AND PROFIT DATA FOR DAWSON INTERNATIONAL**

**DAWSON INTERNATIONAL  
TURNOVER AND OPERATING RESULT**

|                                | 20X7 20X6 20X5        | 20X4 20X3 20X2 20X1 20X0        |
|--------------------------------|-----------------------|---------------------------------|
| Ongoing operations             | 47.7 53.5 63.9        | 70.2 68.3 61.2 75.5 90.7        |
| Acquisitions – Dorma bed linen | 44.9 48.5 47.7        |                                 |
| Discontinued operations        |                       | 10.3                            |
| <b>TURNOVER</b>                | <b>92.6 102 111.6</b> | <b>70.2 68.3 61.2 75.5 101</b>  |
| <b>Operating profit/(loss)</b> | <b>-1.1 -3.1 3.9</b>  | <b>2.6 -18.1 -8.3 -4.3 -1.7</b> |

In 20X5 Dawson acquired the bed linen business of Dorma. I have continued to show the split of turnover after this date so the decline in the underlying Dawson business is clear (Table 10.1). The turnover of the cashmere business has almost halved in eight years. This is likely to be due to competition from suppliers of the same products who are situated in countries with lower costs, particularly with lower labor costs.

The cash flows of Dawson International for the same eight years are summarized in Table 10.2. The operating cash margin is generally negative. This item contains both the positive or negative cash margin from trading in the year and the one-off costs associated with reducing the size of the business year on year. One of the features of the legal and regulatory environment of developed nations is that there are barriers to exit (the opposite of barriers to entry) in the form of redundancy costs (payments required by law in the UK to employees to compensate them for the loss of their employment) when labor numbers are reduced, together with other one-off costs associated with the reduction in size or cessation of business.

In some years working asset investment is contributing to cash flow, as the value invested in inventory and debtors less creditors reduces. Capex is low and in some years the proceeds of disposal of Capex is also contributing to cash flows. One of the difficulties of being in decline is that if you sell off your fixed assets cheaply to someone else you may create a competitor with lower costs than your own until those fixed assets wear out. The solution to this problem used to be to sell the assets into a territory where you do not compete. However, this does not work anymore as the goods produced using the discounted assets can still end up competing in your market due to the ease with which goods move internationally.

With the exception of the Dorma acquisition the Dawson group has been steadily selling off businesses and assets. The most recent transaction being the sale and leaseback in 20X7 of the manufacturing site at Kinross generating £3.5 million cash. The business carried net debt of £5.7 million at the end of 2007. The cash flows of Dawson International represent a good example of decline-phase cash flows.