

Building Cash Flow Summaries from Financial Statements

Not every engagement comes with a ready-made cash flow statement. This course teaches you how to construct a cash flow summary directly from profit and loss accounts and balance sheet data—a valuable skill when working with clients whose reporting is limited. You'll also learn how to summarize historic free cash flow in a way that supports meaningful analysis. Professionals who work with smaller businesses or non-public entities will find these techniques especially applicable to their day-to-day practice.

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

- Identify problems an analyst would encounter if a cash flow statement is not available.
- Recognize the components of free cash flow.
- Identify issues of forecasting cash flows.

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Chapter 1: GENERATING A CASH FLOW SUMMARY FROM PROFIT AND LOSS ACCOUNT AND BALANCE SHEET DATA

Chapter Objective

After completing this chapter, you should be able to:

- Identify problems an analyst would encounter if a cash flow statement is not available.

This chapter deals with the process of estimating cash flow information from profit and loss account (P&L) and balance sheet data.

Before reading this chapter it is essential that the reader has read and digested the earlier chapters on summarizing and evaluating cash flows in Jury's Cash Flow Template format. Virtually all of the terminology used in this chapter has been introduced and explained earlier in the course.

THE NATURE OF THE PROBLEM

There are a variety of risk management scenarios where there may be a desire on the part of the analyst or a counterparty to identify and assess the cash flow performance of a business that does not publish a cash flow statement. Those involved in credit-based transactions and those who are considering the purchase of a business are two examples.

Small- and medium-sized businesses in the UK are not required to publish cash flow statements when they file accounts. This concession to smaller businesses is common in other parts of the world. Business performance information is typically presented to an analyst or other interested parties in the form of a profit and loss account (P&L) and balance sheet. Secondly, much management information, particularly in product-based companies is focused around P&L and balance sheet information.

So, if we wish to examine an entity's cash flow performance, what can we do about this problem?

Earlier in the course we found out that cash flow statements can be prepared using two possible methods, the direct method and the indirect method. The indirect method derives the cash flow statement from P&L and balance sheet data. It follows that it should be possible for an analyst to do the same in the absence of a published cash flow statement and, indeed, it is!

Before we examine the process, it is important to understand the limitations of assembling the estimated cash flow information in this way. What we will end up with is typically not identical to the equivalent published cash flow statement. It will be an approximation of the true cash flow

performance. Typically, the numbers we end up with are likely to be within, say, 10% of the actual cash flow values, indeed, they may be considerably more accurate than this.

Why do these differences arise?

Accruals and Prepayments

The values disclosed in the P&L and balance sheet are adjusted for items that have been used or consumed but not invoiced or paid for (accruals) and items that have been paid for in advance but not fully consumed (prepayments). These adjustments do not represent cash flows and should be reversed. This concept has already been explained in detail in Chapter 3 of course 21705B – *Cash Versus Profit as a Measure of Performance*.

It is not usually possible to adjust for these individually because there is typically no disclosure of them individually. However, in situations where the business is operating normally this should not distort the resulting cash flow estimation too much because the same process of identifying and adjusting for accruals and prepayments occurred at the beginning of the financial period. In other words when we use an income or expense value from the P&L for cash flow estimation purposes, we are not using the actual cash flow received or paid in the period (of say 12 months), we are using a value that represents the 12 months actual physical sales or cost consumed. Both relate to 12 months of income or expense, however, the cash received or paid typically lags the values reported in the P&L by the credit period granted or received from customers and suppliers.

Lack of Disclosure

When we studied the detailed restatement of the operating cash flow of a business in Chapter 2 of course 21702B we discovered a whole variety of adjustments that might be required to restate the operating profit (EBIT) value (or other profit value starting point), to reflect the corresponding OPERATING CASH MARGIN. Typically, some of these adjustments will not be disclosed when working from P&L and balance sheet data. Therefore, we won't be aware of them and, as a result, they will be absent from our final estimates.

The most significant adjustment to profit is typically depreciation/amortization; this is usually disclosed in the P&L and or balance sheet. We may also have disclosure of the profit/loss on disposal of fixed assets in the notes to the P&L. We are unlikely to have detailed information disclosed about movements in provisions and other non-cash items. Ideally, we should have all these in order to correctly arrive at the OPERATING CASH MARGIN.

Changes in the Composition of a Group

If we are seeking to identify the cash flows of a group, and the group has acquired or disposed of subsidiaries during the year, the changes identified from the balance sheet for both working assets and fixed assets are unlikely to match the values that would be revealed were there a cash flow statement available. To illustrate why this might be the case consider inventory. If I acquire a

business during the year with holdings of inventory this will be measured and consolidated at the period end, however the opening inventory of the acquisition will not be in the opening balance sheet inventory value. If we are aware of this problem we can attempt to adjust for it if there is sufficient disclosure. Usually this is not the case.

SO, IS AN ESTIMATED CASH FLOW SUMMARY USEFUL?

Does this mean there is no value in trying to create a summary of cash flows from P&L and balance sheet data? I believe the process is still meaningful, because of the concept of materiality. If we identify the significant values approximating to the actual cash flow values we will still obtain a useful impression of the overall cash flow performance of the entity under examination. It is not necessary for our cash flow values to be absolutely correct for us to gain beneficial insights about the cash flow performance of the entities.

So, what is the process?

Rather than attempting to reconstruct a complete cash flow statement in accordance with IAS GAAP the recommended approach is to come up with a best estimate of the cash flow values that appear in each line of Jury's Cash Flow Template. This requires far less knowledge of double entry bookkeeping and the preparation of statutory accounts than would be required to attempt to complete a statutory cash flow statement. Let us now examine each line of the template and discuss how best to identify the appropriate values for each line (Table 16.1).

TABLE 16.1 LABELING THE CONTENT OF THE TEMPLATE

DATA LINE	JURY'S CASH FLOW TEMPLATE
NUMBER	SUMMARY CASH FLOW HEADINGS
1	OPERATING CASH MARGIN
2	(INVESTED)/GENERATED FROM NET WORKING ASSETS
3	NET CAPITAL EXPENDITURE
4	TAXATION
Sub-total	CASH FLOW AVAILABLE TO SATISFY FINANCE PROVIDERS
5	NET INTEREST
6	NET DIVIDENDS
7	OTHER NON-OPERATING INCOME/(EXPENDITURE)
Balancing total	NET CASH IN/(OUT) BEFORE FINANCING
	Financed by:
8	CHANGE IN EQUITY INCREASE/(DECREASE)
9	CHANGE IN DEBT INCREASE/(DECREASE)
10	CHANGE IN CASH (INCREASE)/DECREASE
Balancing total	TOTAL CHANGE IN FINANCING

The contents of each line of the template have already been explained in detail in Chapter 1 of course 21701B of course 21701B, Chapter 2 of course 21701B of course 21701B, Chapter 2 of course 21701B of course 21702B. I do not intend to repeat that material here. It is assumed that readers have already familiarized themselves with this material. I will simply summarize what each line of the template represents before explaining the various methods for developing a best estimate from the P&L and balance sheet data. Readers should revisit the earlier chapters if they are unfamiliar with any of the terms or methods mentioned.

1. Operating Cash Margin

The operating cash margin in the template represents the cash received from selling goods and services less the cash costs of producing them. In a cash flow statement prepared using the indirect method this value is derived by taking a profit value from the P&L, adjusting it for non-cash income or expense items and removing any other income or expense recognized as profit or loss which does not relate to operations.

The first quick crude estimate of the OPERATING CASH MARGIN is *EBITDA (earnings before interest, tax, depreciation, and amortization)*. In the simplest situation, where there are no other adjustments for non-cash items, EBITDA is the OPERATING CASH MARGIN. When there are a number of adjustments disclosed, the add-back of depreciation and amortization is usually by far the largest item adjusted for.

Typically there will also be a value disclosed in the notes to the P&L for the *profit and loss on the disposal of fixed assets*. This also represents a non-cash adjustment to depreciation and should also be used to adjust the starting EBIT value. Be careful to get the signage right when adding back or deducting the value.

In some situations there may also be some disclosure of *movements in provisions* in the notes to the accounts (this may be also deduced indirectly by looking at the changes in any operating provisions disclosed separately in the opening and closing balance sheet). If there is adequate disclosure of *movements in operating provisions* the EBIT value can also be adjusted for these items.

These are typically the main items. If there is any other disclosure of items relevant to the estimation of the OPERATING CASH MARGIN then they can also be adjusted for to further improve the quality of the resulting estimate.

2. (Invested)/Generated from Net Working Assets

The amount invested or generated from net working assets in the template represents the sum of the change during the reporting period in the amounts invested in inventory, debtors (receivables) and creditors (payables).

The usual way of determining this value is to take the opening and closing values for the three items from the opening and closing balance sheet and identify the differences. An illustration of this is shown in Table 16.2.