

## The Essentials—Cash Flow Statements



A statement of cash flows provides investors with information about cash inflows and outflows and the resulting change in cash and cash equivalents. For this purpose cash flows are classified into three key activities: operating, investing and financing.

### Making the most of cash flow statements

We all know the cliché that ‘cash is king’. For many investors, cash and cash flow are not only a critical area of focus when analysing value and value creation, they also help in analysing liquidity.

Despite its omnipotence in the world of valuation, investors tell us that the practicalities of assessing cash flow can present challenges to even the most seasoned investment professional.

In the first issue of *The Essentials*, we offer some insight on the accounting Standard<sup>1</sup> that covers the cash flow statement and discuss how it plays a role as an input in commonly used methods of assessing a company’s cash-generating capabilities.

#### Inside this issue:

- What you need to know about the cash flow statement
- How do investors commonly look at free cash flow valuation?
- Areas of debate about the cash flow statement
- IFRS vs US GAAP

#### What you need to know about the cash flow statement

In this issue, we highlight four essentials for reading and using the cash flow statement.

##### 1. The buckets

To help analysts assess how different types of activity affect a company’s financial position, cash flows are classified by: operating, investing and financing activities.

**Operating activities:** this is where cash flows that generally result from transactions and other events that determine profit or loss (P&L) are reported. Typical examples include: cash from the sale of goods and rendering of services, cash payments to suppliers and cash payments to employees.

**Investing activities:** this is where investors find expenditures for items that are ultimately intended to generate future income and cash flows. This information supports analysts’ efforts to analyse capital expenditures (‘capex’).

Typically, this involves analysing cash payments made to acquire property, plant and equipment, intangibles, other long-term assets and purchases of new businesses.

**Financing activities:** these cash flows come from activities that can change the size of the company’s capital base—whether it consists of shareholders’ equity or borrowings. Analysts may rely on this information to forecast claims on future cash flows by capital providers. Typical examples include: proceeds from issuing shares, payments to owners, proceeds from issuing debt and repayments of borrowings.



<sup>1</sup> IAS 7 Statement of Cash Flows.

## 2. Three buckets: one statement

By requiring companies to consider transactions through the lens of operating, investing and financing activities, the cash flow statement is organised in a manner that can support many investors' methods of analysing the present value of future cash flows and of making comparisons across companies.

As part of this, different cash flows from the same transaction can be classified in more than one bucket. For example, a cash repayment of a loan that includes principal and interest would see the interest portion classified as operating or financing, while the principal repayment would be classified as financing.

*No matter whether a company makes telecom equipment, cars, or candy, it's still the same question: How much cash do we get and when?*

Warren Buffett and Charlie Munger



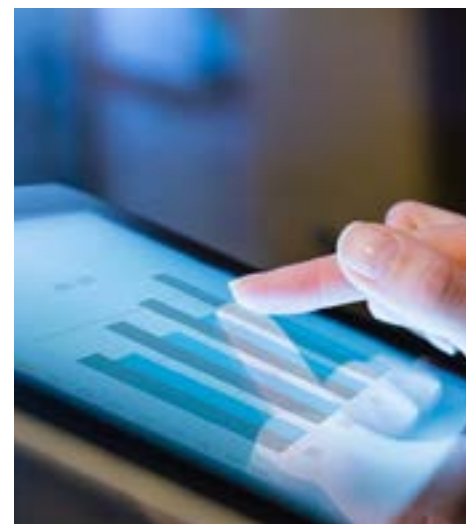
## 3. Two ways to present a cash flow statement

Management can choose one of two ways to present the operating activities in the cash flow statement.

**The direct method:** this is not commonly used (except in a few jurisdictions, such as Australia). It displays major classes of gross cash receipts and payments.

**The indirect method:** this is the more commonly used method of presenting operating activities in the cash flow statement. It is important to appreciate that under this method investors receive a statement reconciling the P&L with operating cash flows, instead of a statement of inflows and outflows.

This reconciliation allows investors to see the effect of accruals of key items in the P&L, including non-cash transactions, deferrals and accruals of operating cash receipts, and deferrals and accruals of operating cash payments. Many investors tell us that they analyse the effect of accruals to obtain an indication of 'earnings quality'. For example, if a company's net income is much higher than its operating cash flow, an analyst may further investigate the company's earnings quality to understand whether this could be explained by accounting choices or by particular operating activities.



## How do investors commonly look at free cash flow valuation?



For many investors, the core concept in estimating free cash flow is the excess of a company's operating cash flows over its capital expenditures. Applying free cash flow in intrinsic valuation methods, such as a discounted cash flow model (DCF), is often considered to be more appropriate than simply using the disclosed operating cash flow. This is because it considers the cash flows available to owners after funding the investment (or reinvestment) needs

of the business. To enable this analysis to be as precise as possible, companies are encouraged to disclose separately cash flows that increase operating capacity and those required to maintain it (some investors refer to this as 'maintenance capex' vs 'growth capex'). As well, these measures of a company's cash flow can be used as an indicator of financial strength, which may be useful to investors analysing a company's ability to repay debt.

#### 4. No statement is an island!

No financial statement should be taken in isolation. Indeed, an unwary investor who looked only at the cash flow statement could miss out on important information contained elsewhere in the financial statements. For example, investing activities can often include non-cash transactions—one instance would be when finance leases are used to obtain property, plant and equipment (PP&E). This introduces a potential ‘capex blind spot’ into an investor’s analysis. When cash is used to purchase PP&E, an analyst would see this capex cash flow classified in investing activities. However, PP&E acquired via a finance lease is a non-cash investing transaction that results in assets and liabilities being recognised in the balance sheet without any corresponding cash flows presented in the cash flow statement.

This capex blind spot could result in a mismatch between what the analyst perceives to be the company’s cash generating capabilities relative to the associated investment needs.



To help investors to overcome this potential analytical hazard, companies are also required to disclose non-cash transactions (investing and financing) elsewhere within the financial statements. This information can be used to provide other ‘cash-related’ measures that could prove useful in an analysis.



#### Areas of debate about the cash flow statement

There are a variety of views on virtually every aspect of financial reporting. Because of the importance of cash flows in the valuation process, it is not surprising that this is an area that stimulates hot debate. Commonly cited areas of concern include:

- Dividends and interest paid can be classified as either operating or financing activities. This results in some diversity in reporting practices across companies, requiring analysts to make appropriate adjustments when making comparisons. For instance, if a company classifies interest paid in the financing section of the cash flow statement, then the analyst may adjust the reported operating cash flow by this amount when calculating free cash flow for valuation purposes. Conversely, interest paid that is reported within operating activities may be reclassified to financing by investors who focus on assessing the company’s ability to service debt.
- Expenditures on research and development activities are classified as cash from operating activities; however, some analysts consider these to be long-term investments in future income generating activities.

#### What is the most helpful starting point for reconciling the P&L to operating cash flow?

The presentation of operating profit under the indirect method of the cash flow statement can start with either P&L before or after tax. An investor’s ability to make comparisons across companies may be affected if different starting points are presented in the reconciliation.



## IFRS vs US GAAP

This is an area of accounting in which IFRS and US GAAP may differ. Look behind the numbers before comparing across borders!

Cash flow item	IFRS	US GAAP
Payments: interest paid	Operating or financing	Operating
Payments: dividends paid	Operating or financing	Financing
Receipts: interest received	Operating or investing	Operating
Receipts: dividends received	Operating or investing	Operating

The following example illustrates how a company might present its statement of cash flows using the indirect method. It demonstrates the more common reconciliation of profit before taxes to operating activities used by many companies. This example is not part of the accounting Standard and as such it should not be interpreted as guidance on implementing the cash flow statement requirements, or as a commentary on particular subtotals used by companies.



EXAMPLE	20X7
<b>Operating activities:</b>	
Profit before taxes	771
<b>Adjustments for:</b>	
Depreciation, amortisation, impairment losses	235
Unrealised foreign exchange losses/(gains)	7
Interest income	(17)
Interest expense	50
Operating profit before working capital changes	1,046
Increase in receivables and other assets	(210)
(Increase)/decrease in inventories	(205)
Increase in accounts payable and other liabilities	112
Cash generated from operations before interest and taxes	743
Interest paid	(46)
Income taxes paid	(268)
<b>Net cash generated from operating activities</b>	<b>429</b>
<b>Investing activities:</b>	
Purchase of trademarks	(35)
Proceeds from sale of trademarks	10
Purchase of property, plant and equipment	(290)
Proceeds from sale of property, plant and equipment	3
Proceeds from sale of short-term financial assets	154
(Purchase of)/proceeds from investments	(14)
Interest received	17
<b>Net cash used in investing activities</b>	<b>(155)</b>
<b>Financing activities:</b>	
Repayments of long-term borrowings	(68)
Proceeds from issue of convertible bond	85
Repayments of finance lease obligations	(1)
Dividend paid to shareholders	(192)
Proceeds from short-term borrowings	46
Repayments of short-term borrowings	(150)
<b>Net cash (used in)/generated from financing activities</b>	<b>(280)</b>
<b>Effect of exchange rates on cash</b>	<b>(24)</b>
(Decrease)/increase of cash and cash equivalents	(30)
Cash and cash equivalents at beginning of the year	1,420
<b>Cash and cash equivalents at the end of the year</b>	<b>1,390</b>

- Reconciling P&L to cash flow from operating activities
- Reflecting expenditures on resources intended to generate future income and cash flows
- Reflecting transactions that can affect the company's equity and borrowings

### Contact us

If you would like to learn more about cash flow reporting, *The Essentials* series or the IASB's investor engagement activities, visit: [go.ifrs.org/Investor-Centre](http://go.ifrs.org/Investor-Centre).

This issue of *The Essentials* has been compiled by the IFRS Foundation Education Initiative staff. The IFRS Foundation is an independent, not-for-profit organisation working in the public interest. One of the principal objectives of the IFRS Foundation is to develop a single set of high quality, understandable, enforceable and globally accepted International Financial Reporting Standards (IFRS) through its standard-setting body, the International Accounting Standards Board (IASB).

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