# Solving The Puzzle Of The Cash Flow Statement

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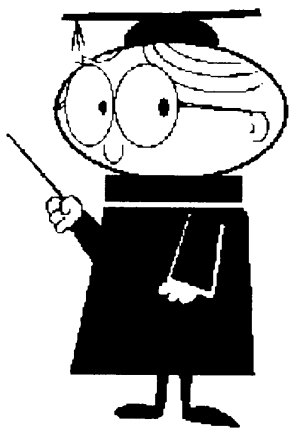
The cash flow statement is one of the most useful financial statements companies prepare. When analyzed in a rational, logical manner, it can illuminate a treasure trove of clues as to how a company is balancing its receivables and payables, paying for its growth, and otherwise managing its flow of funds. But many readers seem to bypass the cash flow statement and head only for the old, familiar, comfortable income statement and balance sheet—despite the fact that the cash flow statement may provide considerable information about what is really happening in a business beyond that contained in either of the other two statements.

A Business Horizons tutorial.



There are several reasons why the cash flow statement may not get the attention it deserves. First, although it has been around in its present format since mid-1988, it is still considered the "new statement"; many managers were not exposed to it during their business schooling in financial analysis. If they were, they may have been taught how to prepare one but not how to interpret the story it tells.

Second, the format of the "Cash Flow from Operating Activities" section of the statement can be challenging to follow if presented in what is known as the "indirect" method. But perhaps most daunting to many is the mistaken idea that it takes a very sophisticated analysis of complicated ratios and relationships to use a cash flow statement effectively.

Contributing to this notion are numerous business journal articles that have appeared in the past decade. They promote the value of this statement when appropriate cash flow ratios are used in statistical packages, such as those used to predict bankruptcy. Present day textbooks, when not merely teaching students to prepare the statement, also concentrate on describing how ratios such as "free cash flow to net income" can be derived, but say little about what truly useful information these ratios or other information from the cash flow statement may provide.

Analyzing this statement should not present a formidable task when reviewed in the manner we are advocating here. Instead, it will quickly become obvious that the benefits of understanding the sources and uses of a company's cash far outweigh the costs of undertaking some very straightforward analyses. Executives want to know if the cash generated by the company will be sufficient to fund their expansion strategy; stockholders want to know if the firm is generating enough cash to pay dividends; suppliers want to know if their customers will be able to pay if offered credit; investors want to evaluate future growth potential; and employees are interested in the overall viability of their employer as indicated by its ability to fund its operations. These are just a few of the valuable insights to be gained from the cash flow statement.

The method we suggest for studying this valuable statement contains several steps, with the preliminary step consisting of gaining a basic understanding of the format of the cash flow statement. Once a certain "comfort level" with the structure of the statement has

been attained, individual companies' statements should be examined to gain practice in using the stepwise approach described shortly. These steps consist of:

1. scanning the big picture;
2. checking the power of the cash flow engine;
3. pinpointing the good news and the bad news; and
4. putting the puzzle together.

Pay attention, for you will be tested on your new expertise at the end of this article!

## Format Of The Cash Flow Statement

The cash flow statement is divided into three sections: operating activities, investing activities, and financing activities. **Figure 1** presents an example of a simple cash flow statement with the three sections delineated in bold letters. Each section shows the cash inflows and outflows associated with that type of activity.

*Cash flow from operating activities* shows the results of cash inflows and outflows related to the fundamental operations of the basic line or lines of business in which the company engages. For example, it includes cash receipts from the sale of goods or services and cash outflows for purchasing inventory and paying rent and taxes. You will notice it does not show these items directly. It assumes that most of these cash inflows and outflows are already summarized in the "Net Income" figure, so it starts at that figure and makes an adjustment for everything that is not a true representation of "cash in and out" in net income. This approach is the "indirect format" of presenting cash flows from operating activities and is the one chosen by most companies. The indirect format can be confusing, and a longer explanation of "direct versus indirect" formats is provided in **Figure 2** for readers who desire more information.

Regardless of how the cash flow from operating activities section is formatted, it is important to remember that this is the most important of the three sections because it describes how cash is being generated or used by the primary activities of the company. To picture activities that affect cash flow from operations, think of the cash receipts and payments that make most working capital accounts on the balance sheet increase or decrease. For example, accounts receivable decreases when cash is collected from customers, inventory increases when goods are purchased, and accounts payable decreases when suppliers are paid for their goods.

The next section is called *cash flow from investing activities*. Here you see the cash flows associated with purchases and sales of non-current assets, such as building and equipment purchases, or sales of investments or subsidiaries. An easy way to picture what activities would be here is to think again of a balance sheet. If you assume current assets are associated with operations, then the activities associated with all the rest of the assets are in this section.

**Figure 1**
**Statement of Cash Flows**

| | |
|---|---|
| **Cash Flow from Operating Activities** | |
| Net Income | XXX,XXX |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Depreciation and amortization | XX,XXX |
| Changes in other accounts affecting operations: | |
| (Increase)/decrease in accounts receivable | X,XXX |
| (Increase)/decrease in inventories | X,XXX |
| (Increase)/decrease in prepaid expenses | X,XXX |
| Increase/(decrease) in accounts payable | X,XXX |
| Increase/(decrease) in taxes payable | X,XXX |
| Net cash provided by operating activities | XXX,XXX |
| **Cash Flow from Investing Activities** | |
| Capital expenditures | (XXX,XXX) |
| Proceeds from sales of equipment | XX,XXX |
| Proceeds from sales of investments | XX,XXX |
| Investment in subsidiary | (XXX,XXX) |
| Net cash provided by (used in) investing activities | (XXX,XXX) |
| **Cash Flow from Financing Activities** | |
| Payments of long-term debt | (XX,XXX) |
| Proceeds from issuance of long-term debt | XX,XXX |
| Proceeds from issuance of common stock | XXX,XXX |
| Dividends paid | (XX,XXX) |
| Purchase of treasury stock | (XX,XXX) |
| Net cash provided by (used in) financing activities | (XX,XXX) |
| **Increase (Decrease) in Cash** | **XX,XXX** |

The third section is called *cash flow from financing activities*. Again, the balance sheet provides a handy way of discerning what would be in this section. If you eliminate the current liabilities associated with operations, then the activities of all the rest of the liabilities and the stockholders' equity accounts are summarized here.

These are all the flows associated with financing the firm, everything from selling and paying off bonds to issuing stock and paying dividends.

Warning! There are exceptions to everything and the cash flow statement format has a few to watch out for. Two working capital accounts, one asset and one liability, are dealt with outside the cash flow from operating activities section. Short-term marketable securities are treated as long-term investments and appear in cash flow from investing activities; similarly, short-term debt is treated as long-term debt and appears in cash flow from financing activities.

Another anomaly is the treatment of interest and dividends. Although dividends are handled as a cash outflow in the cash flow from financing activities section, interest payments are considered an operating outflow, despite the fact that both are payments to outsiders for using their money! In some countries, such as the United Kingdom, interest payments are included in the financing activities section. But in the United States, the Financial Accounting Standards Board (FASB) voted that interest payments should be in the operating activities section instead. In such a situation, one might have to adjust somewhat if one were trying to compare a UK company like British Petroleum to a U.S. company like Exxon.

### Step 1: Scanning The Big Picture

Now, sit back with your favorite company's annual report and follow these steps to understanding its cash flow picture. You can think of this as a big puzzle exercise. All the pieces are there in the statement; your task is to put them in the proper context to form a mosaic from which a picture of the firm's cash flow health emerges. If you don't have an annual report handy, you can use **Figure 3**, which shows the cash flow statements for the Colgate-Palmolive Company for the years ending 1992, 1993, and 1994. We chose Colgate-Palmolive because it represents one of the best annual reports in the country and the positive trends are clear for illustrative purposes. Other reports may not contain such "rosy scenarios," as you will discover shortly.

Scanning the big picture involves several substeps. The first is to place your company in context in terms of its age, industry, and size. We expect mature companies to have different cash flows from start-up companies, and service industries to look different from heavy manufacturing industries. Big corporations may experience declining cash flows in certain years, but the sheer immensity of their cash flows may ameliorate concerns, whereas the declining trend might be much more worrisome if they were small firms without such vast resources.

Colgate-Palmolive certainly qualifies as a mature company. It is huge (figures are rounded to millions), and it operates primarily in consumer product markets throughout the world. A firm like this should be involved in complex activities on a global scale. Colgate-Palmolive certainly is, but its cash flow statement is not much more complex than what one might expect from a much smaller, perhaps simpler, company.

Continue your big picture scan by flipping through the annual report to determine how management believes the year has progressed. Was it a good year? Perhaps a record-breaking year in terms of revenues or net income? Or is management explaining how the company has weathered some rough times?

A key part of the big picture scan is to look at a key summary figure of financial health—net income. If the cash flow statement has been prepared using the indirect method for operating cash flows, as Colgate-Palmolive's has, you can find this at the top of the cash flow statement. Otherwise you'll have to use the reconciliation of net income and operating cash flows that accompanies the cash flow statement, or take a peek at the income statement itself. What is the bottom line? Does it show income or losses over the past few years? Is income (or loss) growing or shrinking? Keep these points in mind as you examine the cash flows. In addition, scan the comparative numbers for the past three years for unusual items you'd like to have explained eventually.

Colgate-Palmolive shows positive net income for all three years—a promising start. The three-year trend appears to be positive, but a big drop in 1993 raises a few questions. The statement also reveals a few items that need to be checked out. In the operating activities section, what is that "cumulative effect on prior years of accounting changes" in 1993? And what are those "restructured operations"? File those away to examine later. Note any line items that are vastly different from year to year. Colgate-Palmolive has a few of those, including changes in its working capital accounts, the proceeds from issuance of debt, and its purchases of treasury stock.

### Step 2: Checking The Power Of The Cash Flow Engine

The cash flow from operating activities section is the cash flow engine of the company. When this engine is working effectively, it provides the cash flows to cover the cash needs of operations. It also provides cash necessary for routine needs, such as the replacement of worn-out equipment and the payment of dividends. There are exceptions, of course. Start-up companies, for example, usually have negative cash flows from operating activities because their cash-flow engines are not yet up to speed. Companies in cyclical industries might have negative operating cash flows in a "down" year; a company that has experienced an extensive strike could also be expected to have negative cash flow from operating activities. Although occasional years of negative cash flow from operating activities do not spell disaster, on the average we should expect it to be positive.

# Figure 2 Cash Flow From Operating Activities: Direct and Indirect Formats

The cash flow from operating activities section of a cash flow statement can be presented using the direct format or the indirect format. The bottom line is the same, but the two begin at different points. Companies are free to choose either format.

*A* is an income statement, followed by (*B*) the cash flow from operating activities section for the same company presented in the two different formats.

**A. Income Statement**

| | |
|---|---|
| Sales | $412,000 |
| Cost of goods sold | (265,000) |
| Other expenses | (133,000)[a] |
| Net income | $30,000 |

[a] *Other expenses includes $25,000 depreciation expense.*

The direct method is just like a cash tax return: how much cash came in the door for sales and how much cash went out the door for the inventory and other operating expenditures. Many believe the direct format is better, because it is easier to understand at first glimpse. However, if companies choose the direct format, they must also present a reconciliation between cash flow from operating activities and net income–which is precisely what the indirect format shows! Consequently, most firms simply choose to present the indirect format.

The indirect method starts with net income as a figure that summarizes most of the cash transactions for operating activities in a firm. However, net income also includes transactions that were not cash, so we must eliminate the non-cash transactions from the net income figure to arrive at an accurate presentation of cash flows from operating activities.

A common, typically major expense that does not involve the expenditure of any cash at all is depreciation. Depreciation is always added back to net income under the indirect method. Do not be confused by this presentation into thinking depreciation somehow provides cash. It is only added back because it was subtracted to get to net income in the first place, and it must now be added back to get to cash. If there are other expenses that did not involve cash, these too will be added back to net income.

For most income statement items, the cash paid (or received) could be a little more, or a little less, than the income statement item. For example, cash received from customers could be a little more than revenues, especially if we collected large amounts owed to us from prior years, or it could be a little less if we made significant credit sales this year. Changes in operating working capital accounts reveal whether or not the amounts included in net income for sales, inventory costs, and other expenses really reflect the actual cash inflows and outflows. Changes in these accounts are added back to or subtracted from net income to reveal the true cash inflows and outflows.

Say the total sales number on our income statement was $412,000. But if we examined accounts receivable, we would find that receivables increased by $12,000, which customers essentially "put on their bill," and only $400,000 was actually collected in cash. So the deduction of $12,000 for "increase in receivables" in the indirect format adjusts the sales number of $412,000 down to $400,000, the actual cash received.

The inventory decrease reveals that we used some inventory purchased in prior years for sales this year. Our cost of goods sold figure in net income is therefore too high as an indicator of cash paid this year for inventory.

Similarly, it looks as if we paid some of last year's bills this year, because our payables went down by $8,000. So we must subtract an additional $8,000 to adjust the net income figure for the additional, actual cash expenditures.

There is a simple rule by which accounts should be added to or subtracted from net income: *Increases in current assets are subtracted, and increases in current liabilities are added.* The simplest approach to remember this is to pick a single account that is easy to figure out when it changes in one direction. For example, you might remember that increases in accounts receivable represent goods sold on account, but not for cash; so increases in accounts receivable must be subtracted from net income to reflect cash flows from operating activities. Once you know this, you know that a decrease in accounts receivable must be treated the opposite way: it will be added. Now you can deduce the remaining working capital accounts. The asset accounts will be treated just like accounts receivable. And the liability accounts will be exactly the opposite. Once you know one working capital account, you know them all.

Although initially it takes practice to become familiar with the indirect format, you will discover that it actually shows quite a bit of useful information you might need to search for otherwise. The quickest way to find the company's total depreciation, for example, is on the cash flow statement. In addition, it directly displays the changes in the working capital accounts. If you were to use the balance sheet for this information, you would have to perform the subtraction yourself.

**B. Cash Flow from Operating Activities (two formats)**

| *Direct* | | *Indirect* | |
|---|---|---|---|
| Cash received from customers | $400,000 | Net Income | $30,000 |
| Cash paid to suppliers | (260,000) | Adjustments to reconcile net income to net cash provided, by operating activities: | |
| Cash paid to employees | (70,000) | Depreciation | 25,000 |
| Other cash operating expenditures | (30,000) | | |
| Net cash provided by operating activities | $40,000 | | |
| | | Changes in other accounts affecting operations: | |
| | | (Increase) in receivables | (12,000) |
| | | Decrease in inventory | 5,000 |
| | | (Decrease) in payables | (8,000) |
| | | Net cash provided by operating activities | $40,000 |

**Figure 3**
**Consolidated Statements of Cash Flows: Colgate-Palmolive**

| *(In millions)* | *1994* | *1993* | *1992* |
|---|---|---|---|
| **Operating Activities** | | | |
| Net Income | $ 580.2 | $ 189.9 | $ 477.0 |
| Adjustments to reconcile net income to cash provided by operations: | | | |
| Cumulative effect on prior years of accounting changes | --- | 358.2 | --- |
| Restructured operations, net | (39.1) | (77.0) | (92.0) |
| Depreciation and amortization | 235.1 | 209.6 | 192.5 |
| Deferred income taxes and other, net | 64.7 | 53.6 | (25.8) |
| Cash effects of these changes: | | | |
| (Increase) in receivables | (50.2) | (103.6) | (38.0) |
| (Increase)/decrease in inventories | (44.5) | 31.7 | 28.4 |
| (Increase)/decrease in current assets | (7.8) | (4.6) | 10.6 |
| Increase/(decrease) in payables | 90.9 | 52.6 | (10.0) |
| Net cash provided by operations | 829.4 | 710.4 | 542.7 |
| **Investing Activities** | | | |
| Capital expenditures | (400.8) | (364.3) | (318.5) |
| Payment for acquisitions | (146.4) | (171.2) | (170.1) |
| Sale of securities and investments | 58.4 | 33.8 | 79.9 |
| Investments | (1.9) | (12.5) | (6.6) |
| Other, net | 33.0 | 61.7 | 17.4 |
| Net cash used for investing activities | (457.7) | (452.5) | (397.9) |
| **Financing Activities** | | | |
| Principal payments on debt | (88.3) | (200.8) | (250.1) |
| Proceeds from issuance of debt | 316.4 | 782.1 | 262.6 |
| Proceeds from outside investors | 15.2 | 60.0 | --- |
| Dividends paid | (246.90) | (231.4) | (200.7) |
| Purchase of treasury stock | (357.9) | (657.2) | (20.5) |
| Proceeds from exercise of stock options | 18.5 | 21.8 | 22.6 |
| Net cash used for financing activities | (343.0) | (225.5) | (186.1) |
| Effect of exchange rate changes on cash | (2.9) | (6.2) | (9.3) |
| Net increase (decrease) in cash | $ 25.8 | $ 26.2 | $(50.6) |

To check the cash flow engine, first observe whether cash flow from operating activities is greater than zero. Also check whether it is growing or shrinking. Assuming it is positive, the next question is whether or not it is adequate for important, routine expenditures. Just as we do not expect a start-up company to have positive cash flow from operating activities, we also do not expect a company still in a very rapid growth phase to generate enough cash flow from operating activities to cover the investments required to rapidly expand the firm. However, we do expect the operations of a mature company to generate enough cash to "keep the company whole." This would include the amount of investment required to replace those fixed assets that are used up, worn out, or technologically obsolete as well as cash required to pay the annual dividend shareholders have come to expect.

It is difficult to know precisely how much cash is required to keep the company's fixed assets "whole," because the cash flow statement does not separate capital expenditures for replacement and renewal from those for expansion and growth. However, the annual depreciation amount provides a very rough surrogate for the amount of fixed assets that need to be replaced each year. In periods when prices are rising, the cost to replace assets should be somewhat greater than the cost of older assets that are being depreciated. So to ensure that the firm is kept whole and is not shrinking, we should expect the portion of investing activities related to the purchase of fixed assets to exceed depreciation.

Important information about the cash flow engine is also revealed by examining the operating working capital accounts. In the Colgate-Palmolive operating activities section, these are shown under "cash effects of these changes." In a healthy, growing company, we would expect growth in operating working capital accounts such as inventory and accounts receivable as well as in accounts payable and other operating payables. Obviously there can be quite a bit of variability in working capital accounts from period to period. Streamlining a collections policy or implementing a Just-In-Time inventory system could shrink accounts receivable or inventory in a growing company. But on the average, inventories, receivables, and accounts payable usually grow in expanding companies. Beware of situations in which all working capital accounts increase net cash from operating activities. This likely would not happen randomly in a healthy, growing company. It normally results from deliberate management action and could indicate a company in such a cash flow crisis that managers have been forced to raid the working capital accounts to survive.

With these ground rules, let's check Colgate Palmolive's cash flow engine. In all three years, cash flow from operating activities is greater than zero, reaching over $800 million in 1994. It increases steadily every year, unlike net income. Annual depreciation is in the vicinity of $200 million each year, and the yearly dividend is also around $200 million. Colgate-Palmolive's cash flow engine is not only generating enough cash to cover "keeping the company whole," it is also able to throw off around $400 million annually for growth and investment, and the amount of excess cash has been increasing each year.

This is a powerful cash flow engine. A glance at the working capital account differences indicates that receivables, other assets, and payables have grown (net) over the three years, while inventories have shrunk slightly. This picture is consistent with a global company increasing its scope through acquisitions and new product development.

### Step 3: Pinpointing The Good News And The Bad News

This step involves looking at the total cash flow statement to find where the rest of the "good news" and "bad news" lie. What you are looking for is the story the statement is trying to tell you. It will not come simply by divine revelation, but by systematic observation of the items on the statement and their trends over the years presented for your comparison.

Begin with cash flow from investing activities. What is this section trying to tell you? One systematic observation is to check whether the company is generating or using cash in its investing activities. Whereas we expect positive cash flow from operating activities, we also expect a healthy company to invest continually in more plant, equipment, land, and other fixed assets to replace the assets that have been used up or have become technologically obsolete, as well as to expand and grow. Although companies often sell assets that are no longer of use to them, they would normally purchase more capital assets than they sell. As a result, we generally expect negative cash flows from investing activities. As with operating activities, exceptions do occur, especially if the firm divests a business or subsidiary. However, watch for companies that are beginning to shrink substantially because they are generating much of their cash by selling off chunks of the business!

Colgate-Palmolive exhibits the signs of a "good news from investing activities" company. Capital expenditures are nearly 1.5 times the amount of depreciation, so they are clearly at a level well beyond that required to keep the company whole. In addition, Colgate-Palmolive makes significant expenditures for acquisitions in each year—another growth indicator. These numbers remain consistent or increase from year to year and paint a picture of a steadily growing company, with enough cash flow from operating activities to cover these expenditures and more.

Cash flows from financing activities could as easily be positive as negative in a healthy company. Moreover, they are likely to change back and forth, so finding the "good" and "bad" is more challenging. It requires viewing the cash flows from financing activities in conjunction with other information on the cash flow statement and basing your conclusions on the weight of the evidence and your own judgment. Assume a company has borrowed cash or issued stock. A "good news" scenario might be that the firm has carefully analyzed its leverage and cost of capital and chosen to finance itself through debt or equity rather than from cash from operations. Another "good news" scenario might be that a new start-up is doing well enough to issue an Initial Public Offering. On the other hand, a "bad news" scenario might be that the company has low (or negative) cash flows from operations and is being forced to generate funds from other sources. You must look at the entire package to evaluate whether your cash flows from financing are in the "good news" or "bad news" categories.

One systematic way to begin is to compare borrowing and payments on debt with each other across the years and note the trends. Colgate-Palmolive has been consistently borrowing more than it has paid back, and to a very substantial degree in 1993. Good news or bad? We have already seen the incredible amount of cash being thrown off from operations, so this increase in debt financing is probably the result of a conscious management decision and not the actions of a company desperately borrowing to survive. Nevertheless, it might be worth another more detailed look if we wanted to consider whether continued borrowing provides a likely source of funds for future growth, or whether the firm is nearing its debt capacity.[1]

A second systematic step in uncovering the news in this section is to check the activities in the stock accounts. Colgate-Palmolive is not issuing much stock; instead, it seems to be buying back substantial amounts of treasury stock. In fact, that is the single largest use of cash outside of capital expenditures.[2] This is probably a "good news" scenario, because the company may be cashing in on what it considers a low price for its stock, or perhaps protecting itself from takeover attempts. In either event, Colgate Palmolive appears to have sufficient cash available to make this large, non-routine investment. A little digging in the rest of the financial statements might present the whole story.

### Step 4: Putting The Puzzle Together

In evaluating the cash flow statement, you are evaluating many pieces of evidence to produce an overall picture. However, it would be rare to find a company in which all of the evidence is positive, or in which all of the evidence is negative. To make a balanced evaluation, you must use both the good news and the bad news identified in each section of the statement. To reach an overall conclusion, you need to judge the relative importance of each piece of evidence and assess its relationship to the overall picture. As in a legal case, your conclusion needs to be based on the "weight of the evidence."

Before proceeding with the overall evaluation, one loose end to tie up at this point might be any unusual line items you spotted in your scan of the big picture. Sometimes these demand that you ask an expert, but frequently you can think them through or search for

illumination elsewhere in the annual report. Earlier we identified two unusual line items for Colgate-Palmolive. One was the "cumulative effect on prior years of an accounting change" in 1993. Without the deduction of this $358 million item from income in 1993, Colgate-Palmolive had a healthy income figure of $548 million; but after subtracting it, income fell to $190 million. The explanation is that when Colgate-Palmolive made this accounting change, all of its effects prior to 1993 were charged to income in 1993. In reality, there was not actual expenditure of cash in 1993, which is why we added this back on the cash flow statement.[3] This is good to know, because if we ignore the accounting change and the associated charge, net income has steadily increased.

**Figure 4**
**Jones Company: Statements of Cash Flows**
**For Year Ending December 31**

| *Millions of Dollars* | *1995* | *1994* | *1993* |
|---|---|---|---|
| **Cash Flow from Operating Activities** | | | |
| Net income (loss) | $ (43) | $ (189) | $ (134) |
| Depreciation | 230 | 271 | 350 |
| (Increase) in receivables | (121) | (25) | (4) |
| Decrease in inventories | 50 | 42 | 30 |
| Changes in other current accounts | 16 | (8) | (12) |
| Net cash provided by operating activities | 132 | 91 | 230 |
| **Cash Flow from Investing Activities** | | | |
| Capital Expenditures | (200) | (260) | (300) |
| Disposal of plant assets | 204 | 200 | 180 |
| Disposal of business segment | 134 | 51 | --- |
| Net cash (used in)/provided by investing activities | 138 | (9) | (120) |
| **Cash Flow from Financing Activities** | | | |
| Proceeds of long-term debt | 200 | 450 | 215 |
| Reductions of long-term debt | (460) | (480) | (322) |
| Dividends paid | --- | --- | (30) |
| Net cash used for financing activities | (260) | (30) | (137) |
| Increase (decrease) in cash | $10 | $52 | (27) |

The other unusual line item was called "restructured operations," which Colgate-Palmolive subtracted from net income. This means that the cash flows associated with restructuring operations occurred in a different year from when these costs were expensed on the income statement. In all three years presented by Colgate-Palmolive, it had more cash outflows for restructuring than it expensed in the income statement.

Good news or bad news? When a company restructures some of its operations, there is both. The bad news is that there was some kind of problem that required the restructuring. The good news is that the company recognized the problem and took action it hopes will be effective. Whether the restructuring cash costs are more or less than the restructuring expense is simply a timing issue. Because expenses are recognized as soon as reasonably possible, it typically requires several years after the expense has been recorded for all of the cash costs to be incurred. Colgate-Palmolive probably recognized these restructuring expenses in prior years and this is just the anticipated cash outflows catching up with them. Moreover, the amount on the cash flow statement is declining each year.

Whether or not to chase down explanations for unusual or unknown items is a subjective call. For example, if Colgate-Palmolive's restructuring charge differences were bigger or growing, it might be worthwhile to search for more information. However, the "weight of the evidence" so far indicates that this issue is not particularly relevant in getting at the big picture. If you encounter something you do not understand, consider its materiality. If it has a major effect on cash flow from operating activities, or if it ranks as one of the major sources or uses of cash, you should probably search for an explanation. Otherwise it may be more efficient to ignore it and concentrate on the many items you know.

Now let's summarize what we've learned by examining Colgate-Palmolive's cash flow statement. First, the good news. Net income has been positive for all three years and, if we eliminate the effects of the accounting change, has been steadily increasing. Operating cash flows have also been positive for three years; they, too, have been steadily increasing. Operating cash flows have significantly exceeded the sum of depreciation and dividends, so Colgate-Palmolive is generating enough cash from operations to expand the business. By making capital expenditures that significantly exceed depreciation, and also by making fairly large acquisitions, Colgate-Palmolive shows that it is grooming the business for the future. There are no large-scale sales of fixed assets or divestitures that indicate any downsizing or shrinking of the business. The company has increased its dividend payments annually, an expression of management's confidence in the firm's future cash-generating capability. It also has sufficient excess cash to repurchase large amounts of its stock.

Now the bad news. The presence of charges for "restructured operations" indicates that Colgate-Palmolive has experienced problems in some portions of the business. It has borrowed significantly, in excess of repayment, which could increase leverage. The repurchase of stock could indicate management concerns with possible takeovers. And acquisitions sometimes create problems for firms; it is difficult to integrate them successfully into the company's business to ensure adequate returns.

The good news in the Colgate-Palmolive cash flow story is quite compelling. The bad news is more at the level of "concerns" rather than major cash flow problems.

So considering the weight of the evidence, Colgate-Palmolive appears to have a strong positive cash flow story.

Now it's your turn. The best way to learn about cash flow statements is to study some carefully using the four steps described above. You may not become an expert but you will be able to spot the big trends and important issues involved with the management of cash in most companies.

**Figure 4** provides you with the opportunity to test your newfound skills. It is similar to the puzzles you encountered as a child in which you spot the things that are wrong with the picture. Poor Jones Company is having some rough times, as illuminated by their cash flow statements for 1993, 1994 and 1995. See how many of these troubling developments you can identify by putting together the Puzzle of the Cash Flow Statement! (Some possible answers are listed at the end of the article.[4])

Opportunities for applying your new expertise are many. As an employee curious about your company's ability to cover your paycheck, you can check out the health of cash flow from operating activities. Or suppose you are a supplier whose customer has just announced a loss for the year and you are wondering whether to continue to extend credit. An analysis of the customer's cash flow from operating activities can provide you with evidence that the firm does or does not have strong enough cash flows from operating activities to pay its bills despite losses on the income statement.

If you are a stockholder, you may be interested in whether cash flow from operating activities is large enough to invest in the capital expenditures required to keep the company whole and make it grow while still paying the dividend you have come to expect. As an executive, you might examine the cash flow statement to determine whether it is likely that all of the major sources of cash—operating activities, issuing stock, and borrowing—will be sufficient to fund a major expansion program you plan to undertake. As your expertise increases, many other useful applications may appear to you.

The information contained in a cash flow statement cannot replace the information from the traditional income statement and balance sheet. But it does provide valuable input for understanding the relationships between income and its short- and long-term ability to generate cash.

## Notes

1. This might be the time to go looking for clues in the rest of the annual report. Where to look? A footnote on long-term debt might seem logical, but it is often almost impossible to truly understand unless you are a Chief Financial Officer. Easier and sometimes more illuminating is to do some simple ratios on the balance sheet and income statement. How has debt changed as a percentage of total liabilities and stockholders' equity? For Colgate-Palmolive, the percentage of debt to total liabilities and stockholders' equity is quite high and has gotten higher, from 67% in 1993 to 70% in 1994. The company's income statement reveals that interest expense has almost doubled in the last year, and a quick ratio analysis of "number of times interest can be paid from income" shows a sharp decline from 7 times to about 4½ times in one year. Further examination of the cash flow statement reveals that the company purchased large amounts of treasury stock. This helps explain why stockholders' equity is low in comparison to total equities, which may make that 70% debt-to-total equity ratio more understandable.
2. This contrasts with minor stock repurchases that companies typically undertake to offer stock to employees in stock option plans; in such instances, modest treasury stock repurchases are offset by modest but comparable issuances of treasury stock.
3. An accounting change is just a "paper decision": it affects the way net income is presented, but it does not change the fundamental economic activity of the firm, so it does not affect cash receipts or cash expenditures.
4. Some possible answers are: (1) there have been losses in all three years; (2) depreciation charges have decreased; (3) capital expenditures are less than depreciation; (4) capital expenditures are less than disposals; (5) a big accounts receivable increase needs to be investigated; (6) inventories are decreasing; (7) segments of the business are being sold off; (8) the company has stopped paying dividends; (9) debt needs to be paid off with cash flow from operations; (10) there is much borrowing; (11) there is less borrowing this year. Are creditors trusting the company less?

## References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