



Fisher Funds

Investor Education Centre

*Making investing enjoyable, understandable
and profitable...*

The Statement of Cash Flows

30/08/09

There is simply no more important single document than the statement of cash flows when it comes to valuing a company. While the income statement might provide the headline 'profit' figure, only the statement of cash flows gives you an unbiased view of what a company is up to.

People are often confused as to why we have both the income statement and cash flow statement. Why doesn't a company's revenue equal the cash deposited in the bank?

The answer lies in an accounting concept called accruals. Basically, accrual accounting reflects the fact that often the receipt of cash does not occur at exactly the same time as the goods are sold.

An example is a manufacturing company that sells goods to a long time buyer on credit. The company's income statement would record the sales immediately, but the cash might come in over the next week or month. If the manufacturer was producing and shipping goods to customers faster than they were receiving payment, the income statement would look marvelous but their bank account could be dwindling.

The statement of cash flows is just like your personal bank statement – it shows exactly when cash arrives, and when it leaves. When examining the statement of cash flows the best place to start is the 'cash flows from operations'. This includes all payments and receipts of cash associated with the day to day operations of a company.

Many analysts use operating cash flow rather than profits to value a company, because a company is only worth what it can deliver in the form of cash to investors over the long haul. This is the money that can ultimately be used to expand into new growth markets or pay out to investors in the form of dividends.

From the operating cashflow, we need to make some adjustments to take out one-off items such as capital expenditure and 'non-cash' items like depreciation. For example, if a company sold a subsidiary business for \$10 million in cash, then that money would show up as cash flow, but as it is a one-off and not sustainable, we need to take it out of the calculation. After these adjustments, we are left with what is called 'free cash flow' because it is exactly that, cash that is free to the company to use as it wants.

There is no one ratio or benchmark to determine whether a company's cash flow is good or bad. Depreciation and capital expenditure requirements will differ by company and industry.

Consistency is good - companies that spit out cash every year are often the best performers - and you can compare businesses within the same industry to see which ones are the better cash generators.

The cash flow statement is harder to manipulate or complicate than the income statement – cash is cash after all. If you find a company that has healthy cashflow i.e its cash from operations is more than enough to pay for capital expenditure and interest costs, and the company's earnings are consistently growing as well ... you're on to a winner.

Making investing enjoyable, understandable and profitable...

All information contained in this document is the property of Fisher Funds Management Ltd or its information providers and is protected by applicable copyright and intellectual property laws. All rights reserved. You may not reproduce, retransmit, disseminate, sell, publish, broadcast, or circulate the information without the express written consent of Fisher Funds. You are entitled to use the Information on this Site for your personal, non-commercial use only.