



Learn to Look at the Cash Flow

The Investing Guys (Investopedia.com)

If a company reports earnings of one billion dollars, does this mean they have put this amount of cash in the bank? Not necessarily. Financial statements are based on accrual accounting, which, in an effort to best reflect the financial health of a company, takes into account non-cash items. Sometimes, however, it can be valuable to strip off all the accounting noise and look at how much actual cash a company is generating. The statement of cash flow provides us with this information.

What is Cash Flow?

Cash flow is the constant flow of money in and out of a company. The outflow of cash is the money paid every month to salaries, suppliers, and creditors. The inflow is the money received from customers, lenders, and investors.

All companies provide the cash flow statements as part of their financial statements, but cash flow can also be calculated as [net income](#) plus [depreciation](#) and other non-cash items. Proper cash flow levels vary from industry to industry. A company not generating the same amount of cash as competitors is bound to lose out when times get rough. Even a profitable company (by accounting standards) can go under if there isn't enough cash on hand to pay bills. Comparing amount of cash generated to outstanding debt, known as the cash flow to debt ratio, illustrates the company's ability to service their loan and interest payments.

Unlike for [reported earnings](#), a company can do little to manipulate their cash situation. Every company filing reports with the Securities and Exchange Commission (SEC) is required to include a cash flow statement with their quarterly and annual reports. Unless tainted by outright fraud, this statement tells its whole story: either the company has the cash or it doesn't.

What's the Cash Flow Statement?

The [balance sheet](#) gives a one-time snapshot of a company's [assets](#) and [liabilities](#). The [income statement](#) indicates the business's profitability during a certain period. The cash flow statement differs from these other financial statements because it acts as a kind of corporate checkbook that reconciles the other two statements.

Simply put, the cash flow statement records the company's actual cash transactions during the period. It exposes the reality that all those lovely revenues booked on the income statement may not have been actually collected. At the same time, however, all the expenses the company accrued don't have to be paid right away.

When you look at a cash flow statement the first thing you should understand is the bottom line item that says something to the effect of "net increase/decrease in cash and cash equivalents." This line reports the value of the company's cash and its equivalents, the assets that are cash or can be immediately converted into cash. If you check under current assets on the balance sheet, you will find cash and cash equivalents (C&CE). If you take the difference between the current C&CE and last year's or last quarter's C&CE, you'll get the same number found at the bottom of the statement of cash flows.

The following is a list of the various areas of the cash flow statement and what they mean:

- **Cash Flow From Operating Activities** - This section measures the cash used or provided by a company's normal operations. It shows the company's ability to generate consistently positive cash flow from operations. Think of "normal operations" as the core business of the company. For example, Microsoft's operating activity is selling software.
- **Cash Flows From Investing Activities** - This area lists all the cash used or provided by the purchase and sale of income-producing assets. If Microsoft, again our example, bought or sold companies for a profit or loss, the resulting figures would be included in this section of the cash flow statement.
- **Cash Flows From Financing Activities** - This section measures the flow of cash between a firm and its owners and creditors. Negative numbers can mean the company is servicing debt but can also mean the company is making dividend payments and stock repurchases, which investors might be glad to see.

What Cash Flow Doesn't Tell Us

Cash is one of the major lubricants of business activity, but there are certain things that cash flow isn't very good at telling. For example, cash flow doesn't tell us the profit earned or lost during a particular period. In the statement of cash flow there are numbers like "cash increase from sales minus expenses." At first glance, this sounds like a number that is pretty darn close to profit--but it isn't.

Cash flow also doesn't do a very good job of indicating the overall financial well being of the company. Sure, the statement of cash flow gives a good indication of what the company is doing with their cash and from where cash is being generated, but these do not directly reflect financial condition. The cash flow statement does not account for liabilities and assets, which are recorded on the balance sheet. Accounts receivable and accounts payable, each of which can be very large for a company, are also not reflected in the cash flow statement. In other words, it is a compressed version of the company's checkbook that includes a few other items, like the financing section, which tells the amount of money the company spent or collected from the repurchase or sale of stock, the amount of issuance or retirement of debt, and the amount the company paid out in dividends.

In conclusion, like so much in the world of finance, interpreting the cash flow statement is not a straightforward, black and white issue. You must understand the extent to which a company relies on the capital markets and the extent to which it relies on the cash it has itself generated. Obviously investing in a company that shows positive cash flow is much more desirable, but there are also opportunities in companies that aren't cash flow positive. The cash flow statement is yet another piece to the puzzle. Analyzing the cash flow together with the other statements it can give you a glimpse into the short term viability of a company.

Have a Great Week!

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