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## Analyzing operating activities

The statement of cash flows presents sources and uses of cash in three distinct categories: cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities. Financial statement users are able to assess a company’s strategy and ability to generate a profit and stay in business by assessing how much a company relies on operating, investing, and financing activities to produce its cash flows. Classification of Cash Flows Makes a Difference Assume you are the chief financial officer of T-Shirt Pros, a small business that makes custom-printed T-shirts. While reviewing the financial statements that were prepared by company accountants, you discover an error. During this period, the company had purchased a warehouse building, in exchange for a \$200,000 note payable. The company’s policy is to report noncash investing and financing activities in a separate statement, after the presentation of the statement of cash flows. This noncash investing and financing transaction was inadvertently included in both the financing section as a source of cash, and the investing section as a use of cash. T-Shirt Pros’ statement of cash flows, as it was prepared by the company accountants, reported the following for the period, and had no other capital expenditures. Because of the misplacement of the transaction, the calculation of free cash flow by outside analysts could be affected significantly. Free cash flow is calculated as cash flow from operating activities, reduced by capital expenditures, the value for which is normally obtained from the investing section of the statement of cash flows. As their manager, would you treat the accountants’ error as a harmless misclassification, or as a major blunder on their part? Explain. Cash flows from operating activities arise from the activities a business uses to produce net income. For example, operating cash flows include cash sources from sales and cash used to purchase inventory and to pay for operating expenses such as salaries and utilities. Operating cash flows also include cash flows from interest and dividend revenue interest expense, and income tax. Cash flows from investing activities are cash business transactions related to a business’ investments in long-term assets. They can usually be identified from changes in the Fixed Assets section of the long-term assets section of the balance sheet. Some examples of investing cash flows are payments for the purchase of land, buildings, equipment, and other investment assets and cash receipts from the sale of land, buildings, equipment, and other investment assets. Cash flows from financing activities are cash transactions related to the business raising money from debt or stock, or repaying that debt. They can be identified from changes in long-term liabilities and equity. Examples of financing cash flows include cash proceeds from issuance of debt instruments such as notes or bonds payable, cash proceeds from issuance of capital stock, cash payments for dividend distributions, principal repayment or redemption of notes or bonds payable, or purchase of treasury stock. Cash flows related to changes in equity can be identified on the Statement of Stockholder’s Equity, and cash flows related to long-term liabilities can be identified by changes in long-term liabilities on the balance sheet. Can a Negative Be Positive? Investors do not always take a negative cash flow as a negative. For example, assume in 2018 Amazon showed a loss of \$124 billion and a net cash outflow of \$262 billion from investing activities. Yet during the same year, Amazon was able to raise a net \$254 billion through financing. Why would investors and lenders be willing to place money with Amazon? For one thing, despite having a net loss, Amazon produced \$31 billion cash from operating activities. Much of this was through delaying payment on inventories. Amazon’s accounts payable increased by \$78 billion, while its inventory increased by \$20 billion. Another reason lenders and investors were willing to fund Amazon is that investing payments are often signs of a company growing. Assume that in 2018 Amazon paid almost \$50 billion to purchase fixed assets and to acquire other businesses; this is a signal of a company that is growing. Lenders and investors interpreted Amazon’s cash flows as evidence that Amazon would be able to produce positive net income in the future. In fact, Amazon had net income of \$19 billion in 2017. Furthermore, Amazon is still showing growth through its statement of cash flows; it spent about \$26 billion in fixed equipment and acquisitions. Key Concepts and Summary Transactions must be segregated into the three types of activities presented on the statement of cash flows: operating, investing, and financing. Operating cash flows arise from the normal operations of producing income, such as cash receipts from revenue and cash disbursements to pay for expenses. Investing cash flows arise from a company investing in or disposing of long-term assets. Financing cash flows arise from a company raising funds through debt or equity and repaying debt. (Figure)Which of these transactions would not be part of the cash flows from the operating activities section of the statement of cash flows? credit purchase of inventory sales of product, for cash cash paid for purchase of equipment salary payments to employees (Figure)Which is the proper order of the sections of the statement of cash flows? financing, investing, operating operating, investing, financing investing, operating, financing operating, financing, investing (Figure)Which of these transactions would be part of the financing section? inventory purchased for cash sales of product, for cash cash paid for purchase of equipment dividend payments to shareholders, paid in cash (Figure)Which of these transactions would be part of the operating section? land purchased, with note payable sales of product, for cash cash paid for purchase of equipment dividend payments to shareholders, paid in cash (Figure)Which of these transactions would be part of the investing section? land purchased, with note payable sales of product, for cash cash paid for purchase of equipment dividend payments to shareholders, paid in cash (Figure)What categories of activities are reported on the statement of cash flows? Does it matter in what order these sections are presented? Operating, Investing, Financing (always in this order). (Figure)Describe three examples of operating activities, and identify whether each of them represents cash collected or cash spent. (Figure)Describe three examples of investing activities, and identify whether each of them represents cash collected or cash spent. Any transaction that is related to acquiring or disposing of long-term assets like land, buildings, equipment, stocks, bonds, or other investments. Can be cash spent for purchase of long-term assets, or cash collected from sale of long-term assets. (Figure)Describe three examples of financing activities, and identify whether each of them represents cash collected or cash spent. (Figure)In which section of the statement of cash flows would each of the following transactions be included? For each, identify the appropriate section of the statement of cash flows as operating (O), investing (I), financing (F), or none (N). (Note: some transactions might involve two sections.) borrowed from the bank for business loan declared dividends, to be paid next year purchased treasury stock purchased a two-year insurance policy purchased plant assets (Figure)In which section of the statement of cash flows would each of the following transactions be included? For each, identify the appropriate section of the statement of cash flows as operating (O), investing (I), financing (F), or none (N). (Note: some transactions might involve two sections.) collected accounts receivable from customers issued common stock for cash declared and paid dividends paid accounts payable balance sold a long-term asset for the same amount as purchased (Figure)In which section of the statement of cash flows would each of the following transactions be included? For each, identify the appropriate section of the statement of cash flows as operating (O), investing (I), financing (F), or none (N). (Note: some transactions might involve two sections.) purchased stock in Xerox Corporation purchased office supplies issued common stock sold plant assets for cash sold equipment for cash (Figure)Provide journal entries to record each of the following transactions. For each, also identify \*the appropriate section of the statement of cash flows, and \*\*whether the transaction represents a source of cash (S), a use of cash (U), or neither (N). paid \$12,000 of accounts payable collected \$6,000 from a customer issued common stock at par for \$24,000 cash paid \$6,000 cash dividend to shareholders sold products to customers for \$15,000 paid current month’s utility bill, \$1,500 (Figure)Provide journal entries to record each of the following transactions. For each, also identify: \*the appropriate section of the statement of cash flows, and \*\*whether the transaction represents a source of cash (S), a use of cash (U), or neither (N). reacquired \$30,000 treasury stock purchased inventory for \$20,000 issued common stock of \$40,000 at par purchased land for \$25,000 collected \$22,000 from customers for accounts receivable paid \$33,000 principal payment toward note payable to bank financing activity cash business transaction reported on the statement of cash flows that obtains or retires financing investing activity cash business transaction reported on the statement of cash flows from the acquisition or disposal of a long-term asset operating activity cash business transaction reported on the statement of cash flows that relates to ongoing day-to-day operations Learning Objective Analyze cash flow information. Question: Companies and analysts tend to use income statement and balance sheet information to evaluate financial performance. In fact, financial results presented to the investing public typically focus on earnings per share (Chapter 13 “How Do Managers Use Financial and Nonfinancial Performance Measures?” discusses earnings per share in detail). However, analysis of cash flow information is becoming increasingly important to managers, auditors, and outside analysts. What measures are commonly used to evaluate performance related to cash flows? Answer: Three common cash flow measures used to evaluate organizations are (1) operating cash flow ratio, (2) capital expenditure ratio, and (3) free cash flow. (Further coverage of these measures can be found in the following article: John R. Mills and Jeanne H. Yamamura, “The Power of Cash Flow Ratios,” Journal of Accountancy, October 1993.) We will use two large home improvement retail companies, The Home Depot, Inc., and Lowe’s Companies, Inc., to illustrate these measures. Question: The operating cash flow ratioA cash flow performance measure calculated as cash provided by operating activities divided by current liabilities. What does this ratio tell us, and how is it calculated? Answer: This ratio measures the company’s ability to generate enough cash from daily operations over the course of a year to cover current obligations. Although similar to the commonly used current ratio, this ratio replaces current assets in the numerator with cash provided by operating activities. The operating cash flow ratio is as follows: Key Equation Operating cash flow ratio= Cash provided by operating activitiesCurrent liabilities The numerator, cash provided by operating activities, comes from the bottom of the operating activities section of the statement of cash flows. The denominator, current liabilities, comes from the liabilities section of the balance sheet. (Note that if current liabilities vary significantly from one period to the next, some analysts prefer to use average current liabilities. We will use ending current liabilities unless noted otherwise.) As with most financial measures, the resulting ratio must be compared to similar companies in the industry to determine whether the ratio is reasonable. Some industries have a large operating cash flow relative to current liabilities (e.g., mature computer chip makers, such as Intel Corporation), while others do not (e.g., startup medical device companies). The operating cash flow ratio is calculated for Home Depot and Lowe’s in the following using information from each company’s balance sheet and statement of cash flows. Home Depot and Lowe’s are in the same industry and have comparable ratios, which is what we would expect for similar companies. Question: The capital expenditure ratioA cash flow performance measure calculated as cash provided by operating activities divided by capital expenditures, is cash provided by operating activities divided by capital expenditures. What does this ratio tell us, and how is it calculated? Answer: This ratio measures the company’s ability to generate enough cash from daily operations to cover capital expenditures. A ratio in excess of 1.0, for example, indicates the company was able to generate enough operating cash to cover investments in property, plant, and equipment. The capital expenditure ratio=Cash provided by operating activitiesCapital expenditures The numerator, cash provided by operating activities, comes from the bottom of the operating activities section of the statement of cash flows. The denominator, capital expenditures, comes from information within the investing activities section of the statement of cash flows. The capital expenditure ratio is calculated for Home Depot and Lowe’s in the following using information from each company’s statement of cash flows. Since the capital expenditure ratio for each company is above 1.0, both companies were able to generate enough cash from operating activities to cover investments in property, plant, and equipment (also called fixed assets). Question: Another measure used to evaluate organizations, called free cash flow, is simply a variation of the capital expenditure ratio described previously. What does this measure tell us, and how is it calculated? Answer: Rather than using a ratio to determine whether the company generates enough cash from daily operations to cover capital expenditures, free cash flow is measured in dollars. Free cash flowA cash flow performance measure calculated as cash provided by operating activities minus capital expenditures. is cash provided by operating activities minus capital expenditures. The idea is that companies must continue to invest in fixed assets to remain competitive. Free cash flow provides information regarding how much cash generated from daily operations is left over after investing in fixed assets. Many organizations, such as Amazon.com, consider this measure to be one of the most important in evaluating financial performance (see Note 12.34 “Business in Action 12.5”). The free cash flow formula is as follows: Key Equation Free cash flow = Cash provided by operating activities – Capital expenditures The cash provided by operating activities comes from the bottom of the operating activities section of the statement of cash flows. The capital expenditures amount comes from information within the investing activities section of the statement of cash flows. The free cash flow amount is calculated for Home Depot and Lowe’s as follows using information from each company’s statement of cash flows. Because free cash flow for each company is above zero, both companies were able to generate enough cash from operating activities to cover investments in fixed assets and have some left over to invest elsewhere. This conclusion is consistent with the capital expenditure ratio analysis, which uses the same information to assess the company’s ability to cover fixed asset expenditures. Formulas for the cash flow performance measures presented in this chapter are summarized in Table 12.1 “Summary of Cash Flow Performance Measures”. Table 12.1 Summary of Cash Flow Performance Measures Operating cash flow ratio= Cash provided by operating activitiesCurrent liabilities Capital expenditure ratio=Cash provided by operating activitiesCapital expenditures Free cash flow=Cash provided by operating activities – Capital expenditures Free Cash Flow at Amazon.com Amazon.com is an online retailer that began selling books in 1996 and has since expanded into other areas of retail sales. The founder and CEO (Jeff Bezos) believes free cash flow is so important, the annual report included a letter from Mr. Bezos to the shareholders, which began with this statement, “Our ultimate financial measure, and the one we want to drive over the long-term, is free cash flow per share.” The company justifies this focus on free cash flow by making the point that earnings presented on the income statement do not translate into cash flows, and shares are valued based on the present value of future cash flows. This implies shareholders should be most interested in free cash flow per share rather than earnings per share. Mr. Bezos goes on to state, “Cash flow statements often don’t receive as much attention as they deserve. Discerning investors don’t stop with the income statement.” Amazon.com’s free cash flow for 2010 totaled \$2,164,000,000, compared to \$2,880,000,000 in 2009. Net income for 2010 totaled \$1,152,000,000, compared to \$902,000,000 in 2009. It is interesting to note that free cash flow is significantly higher than net income for 2010 and 2009. Three measures are often used to evaluate cash flow. The operating cash flow ratio measures the company’s ability to generate enough cash from daily operations over the course of a year to cover current obligations. The formula is as follows: Operating cash flow ratio=Cash provided by operating activitiesCurrent liabilities The capital expenditure ratio measures the company’s ability to generate enough cash from daily operations to cover capital expenditures. The formula is as follows: Capital expenditure ratio=Cash provided by operating activitiesCapital expenditures Free cash flow measures the company’s ability to generate enough cash from daily operations to cover capital expenditures and determines how much cash is remaining to invest elsewhere in the company. The formula is as follows: Free cash flow = Cash provided by operating activities – Capital expenditures The following financial information is for PepsiCo Inc. and Coca-Cola Company for fiscal year 2010. For PepsiCo and Coca-Cola, calculate the following measures and comment on your results: Operating cash flow ratio Capital expenditure ratio (Hint: fixed asset expenditures are the same as capital expenditures.) Free cash flow Solution to Review Problem 12.8 All dollar amounts are in millions. The formula for calculating the operating cash flow ratio is as follows: Operating Cash Flow Ratio=Cash provided by operating activitiesCurrent liabilities PepsiCo operating cash flow ratio=\$8,448÷\$15,892=0.53 Coca-Cola operating cash flow ratio=\$9,532÷\$18,508=0.52 PepsiCo generated slightly more cash from operating activities to cover current liabilities than Coca-Cola. The formula for calculating the capital expenditure ratio is as follows: Capital Expenditure Ratio=Cash provided by operating activitiesCapital expenditures PepsiCo capital expenditure ratio=\$8,448÷\$3,253=2.60 Coca-Cola capital expenditure ratio=\$9,532÷\$2,215=4.30 Both companies generated more than enough cash from operating activities to cover capital expenditures. The formula to calculate free cash flow is as follows: Free cash flow = Cash provided by operating activities – Capital expenditures PepsiCo free cash flow=\$8,448–\$3,253=\$5,195 Coca-Cola free cash flow=\$9,532–\$2,215=\$7,317 The conclusion reached in requirement two is confirmed here. Both companies generated more than enough cash from operating activities to cover capital expenditures. In fact, PepsiCo had \$5,195,000,000 remaining from operating activities after investing in fixed assets, and Coca-Cola had \$7,317,000,000 remaining.

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