

Net income vs. cash

Understanding the most important financial statement **By Kevin R. Krencisz**

Many financial managers and business owners immediately look to the income statement to determine whether they had a successful year. Others first review the balance sheet to see whether their receivables or line of credit are where they need to be. Savvy businesspeople go directly to the statement of cash flows, which better analyzes activity that appears on both the income statement AND balance sheet. The statement of cash flows begins with net income reported on the income statement and ends with cash as reported on the balance sheet by analyzing three critical areas: operations, investing activities and financing activities.

Analyzing operations via the cash flow statement

The operating section is the most critical because it analyzes the essence of the company. This is the best place to start because every owner always asks the question, "If I made so much money, where did the cash go?" Noncash items such as depreciation expense and loss on sale of assets are added back to net income, and changes in balance sheet accounts are computed to arrive at cash provided by or used in operations. Analysts become concerned when operating cash flow is lower than net income. Two common causes are (1) increases in receivables and (2) increases in inventory.

Consider the example of the selected financial information in the table to the right. The decrease in receivables suggests more cash was collected than was recorded in sales (assuming no bad debt write-offs, which would be detailed separately in the operating section). In this example, collections from customers were \$110,000 (\$100,000 + \$10,000).

The increase in inventory suggests inventory was purchased above the amount sold. The amount was excluded from cost of goods sold because the items have not yet been sold. The increase in payables, however, represents inventory that was purchased with credit and has not yet been paid in cash. In this example, cash paid for inventory equals \$55,000 (\$30,000 + \$40,000 - \$15,000).



From the comparative balance sheet:

Decrease in receivables	\$ 10,000
Increase in inventory	40,000
Increase in payables	15,000

From the income statement:

Net sales	\$100,000
Cost of goods sold	30,000
Net income	200,000

Statement of cash flows:

Net income	\$200,000
Decrease in receivables	10,000
Increase in inventory	(40,000)
Increase in payables	15,000
Cash provided by operations	\$185,000

Pulling it all together

Analysis of trends in investing and financing activities should provide a good picture of how the company is strengthening its

capacity to produce its product by investing in equipment and how it is paying down debt. Once cash flow from operations is computed, \$185,000 in our example, the next question is, "Where did it go?" For discussion purposes, let us say \$50,000 was used in investing activities to purchase equipment and \$125,000 was used in financing activities to repay debt. The net effect for the year would be as follows:

Cash provided by operations	\$185,000
Purchase of equipment	(50,000)
Debt repayment	(125,000)
Increase in cash for the year	10,000
Beginning balance in cash	-0-
Ending balance in cash	\$10,000

The investing and financing activities sections of the cash flow statement can clearly illustrate how the company generated cash, for example, through sales of investments or acquisition of debt, if cash flow from operations was poor. Conversely, it can show how the company invested cash in property and equipment or how it used cash to pay down debt if cash flow from operations was good.

Usefulness of the cash flow statement

The cash flow statement should be prepared and analyzed monthly and annually for trends both positive and negative. It can be used to ascertain the company's ability to generate future cash flow, reveal the differences between net income and net cash flow, clearly illustrate activity in debt and equity securities, and reveal the ability to pay dividends and repay debt. No other financial statement alone can single-handedly present this much information!



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