

CHAPTER 3

Statement of Cash Flows

Understanding the role of the cash-flow statement is crucial for the general analysis of cash flows and in particular for analysis that is based on free cash flow and cost of capital. This is so because the statement reveals important information about the firm's operations, in addition to reconciling balance-sheet changes and financing and investment activities. In financial reporting, there can be a distortion to the cash-flow statement resulting from events that are classified as investing or financing activities instead of operating activities, with the result of such an action providing a boost to both cash flows from operations and free cash flow.

The purpose of the statement of cash flows is to disclose information about economic events that affect cash during the accounting period. Three general types of economic events or activities are described in the statement: operating cash flows, financing cash flows, and investing cash flows. *Operating cash flows* are ongoing operations of a business entity that affect cash, such as collections from customers and payments to suppliers, employees, and the like. *Financing cash flows* are events that affect the financial structure of the firm, such as borrowing cash, repurchasing common stock, and making dividend payments. *Investing cash flows* are the events that affect the long-term assets of a firm, such as purchases of property, plant, and equipment (PPE), sale of investments in subsidiaries, and so forth.

As the Financial Accounting Standards Board (FASB) states in its introduction of *Statement of Financial Accounting Standards No. 95, Statement of Cash Flows* (SFAS 95): "The primary purpose of the statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period." The statement of cash flows provides information about these events if they affect cash during the accounting period. These events that affect cash during a period are important to investors, creditors, suppliers, and employees. Information about operating cash flows indicates the business's

ability to generate cash from its continuing operations. Information about investing cash flows indicates how the business used (received) cash for capital items or liquidated capital to survive downturns. Information about financing cash flows illustrates how the business financed its expansion and partially rewarded stockholders. If a financing event, for example, does not involve cash (such as the conversion of preferred stock to common stock), the information is disclosed in a separate section called “Supplemental information” at the bottom of the cash-flow statement or in the footnotes of the statement of cash flows.

It is important to understand the classifications, especially because it is not uncommon for one entity to place an item as an operating activity, whereas a peer-group entity might place the same item as a finance activity. In general, it is up to the analyst to become familiar with FAS 95 to make any adjustments regarding proper classification. Without doing so, peer comparison and security valuation become difficult.

The sections to follow provide detailed explanations of the components of cash flows, as well as examples from published financial statements. Finally, I discuss how the cash-flow analyst should interpret the cash flows from investing, financing, and operating activities. A follow-up discussion appears in Chapter 8 because various activities here relate to cost-of-capital analysis.

The reader will see why a complete understanding of the items in the cash-flow statement is imperative in risk assessment used to infer a cost of equity and the subsequent determination of fair value. This will allow you to see if a firm is artificially boosting the cash flows it is reporting to shareholders.

CASH FLOWS FROM INVESTING ACTIVITIES

In SFAS 95, the FASB defines cash flows from investing activities as follows:

Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the enterprise (other than materials that are part of the enterprise’s inventory) [SFAS 95, para. 15].

Thus the definition of investing cash flows includes cash outflows used as investments in financial or fixed assets, as well as cash receipts from disposition of such investments. Furthermore, investing cash flows are for investments in financial instruments as well as investments in real assets (PPE). The FASB further describes cash inflows and outflows from investing activities as

Inflows

- a. Receipts from collections or sales of loans made by the enterprise and of other entity's debt instruments (other than cash equivalents) that were purchased by the enterprise.
- b. Receipts from sales of equity instruments of other enterprises and from returns of investment in those instruments.
- c. Receipts from sales of property, plant, and equipment and other productive assets [SFAS 95, para. 16].

Outflows

- a. Disbursements for loans made by the enterprise and payments to acquire debt instruments of other entities (other than cash equivalents).
- b. Payments to acquire equity instruments of other enterprises.
- c. Payments at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other productive assets [SFAS 95, para. 17].

It is more natural to discuss the cash outflows for investing activities prior to financing or operating activities. By analyzing the firm's investment activities, we can see how management deploys its cash. The statement requires the classification of investments in PPE and other productive assets as investing activities. It further restricts the inclusion of these investments in the statement of cash flows to amounts that were paid at the time of purchase or soon before or after the time of purchase. Thus an advance payment for PPE or a down payment will be included. However, a loan by the seller of the PPE will not be included as a cash flow from investing activity because the buyer had not paid for it in cash.

The FASB includes in investing cash flows investments in equity instruments of other enterprises (repurchases of the firm's own securities are classified as financing cash flows), investments in debt instruments of other enterprises, or loans made to other enterprises. The FASB notes that investments in debt instruments of other entities should be "other than cash equivalents." This is an important distinction because the statement of cash flows can be prepared using "cash and cash equivalents." *Cash equivalents* are short-term, highly liquid investments that are both

- a. Readily convertible to known amounts of cash.
- b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates [SFAS 95, para. 8].

The FASB states that generally only investments with original maturities of 3 months or less qualify under the definition of a cash equivalent. Thus, when a treasurer purchases a Treasury note that has 60 days to maturity using cash, an increase in cash and cash equivalents is recorded for the period.¹ However, if the treasurer purchased a 120-day Treasury note, an investing cash flow is recorded on the statement of cash flows. Clearly, these rules leave management some room for manipulation close to the end of the accounting period. It should be noted that the FASB ruled that if a 7-year note, for example, is purchased less than 90 days before maturity, it does not get reclassified as a cash equivalent when the balance-sheet date falls within 90 days of its maturity.

Example:**Cash and Cash Equivalents**

The company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. The company's cash equivalents consist primarily of money market funds, unrestricted deposits, debt instruments of the U.S. Treasury, and commercial paper. Cash includes amounts restricted for letters of credit for purchases and deposits for equipment maintenance of \$528,000 and \$72,000 at June 30, 2009 and 2008, respectively.

Source: 2009 Oplink Communications, Inc., 10K.

It seems reasonable that cash and cash equivalents will include only items that could be readily converted to cash because there should be no question both as to the item's value and its liquidity. In some cases, a portion of the available cash is restricted by compensating balance agreements or other agreements. Restricted cash should not be included in "Cash and cash equivalents" for purposes of the statement of cash flows. However, in some cases, firms deviate from this line of reasoning.

Example:

Compensating balance arrangements that do not legally restrict the withdrawal or usage of cash amounts may be reported as Cash and Cash Equivalents, while legally restricted deposits held as compensating balances against borrowing arrangements, contracts entered into with others, or company statements of intention with regard to particular deposits should not be reported as cash and cash equivalents.

Source: Home Depot, June 2009 10Q.

¹ The decrease in cash is exactly offset by the increase in cash equivalents, the Treasury note, because the maturity of the note is less than 90 days.

Example:

Berkshire Hathaway defines cash equivalents quite differently. As reported, cash held out as backing for loans and other liabilities is listed as part of "Other assets" on its balance sheet. For Berkshire, this can be substantial because the company lists \$9.3 billion of other assets on its 2008 10K. Found in various locations of the company's 10K, we learn that also included in "other assets" are \$1.7 billion of premium acquisition costs and \$0.3 billion of derivative contract assets minus \$0.1 billion in pension assets and \$2.1 billion in regulatory assets. The company footnotes cash and cash equivalents as follows:

Cash equivalents consist of funds invested in U.S. Treasury Bills, money market accounts, and in other investments with a maturity of three months or less when purchased. Cash and cash equivalents exclude amounts where availability is restricted by loan agreements or other contractual provisions. Restricted amounts are included in other assets.

It should be noted that cash flows from investing activities include both cash outflows and cash inflows. The inflows occur when a firm disposes of its investments in financial instruments or fixed assets.² The cash proceeds from sales are included among the cash flows from investing activities and represent disinvesting activities by the firm. Can a firm net cash inflows against cash outflows? For example, can a firm net the proceeds from sales of PPE against additions to PPE? Usually, accountants and investors are against offsetting any type of inflows with outflow, assets against liabilities, or revenues against expenses because to do so could deprive the decision maker of important information regarding current and prospective cash flows. However, if the amount of the proceeds is immaterial, the firm may report the net purchases of PPE.

Most firms disclose in this section cash outlays on capital expenditures, acquisitions, investments in financial instruments, investments in unconsolidated subsidiaries, and purchases of additional shares from minority shareholders. Clearly, each of these investing activities has an opposite counterpart of a disinvesting activity, for instance, the sale of investments.

The cash-flow analyst should investigate the capital expenditures of a firm and the retirement of PPE during the accounting period. Capital expenditures should be sufficient at least to sustain the current levels of operations. They can be compared with past capital expenditures, levels of investments by competitors, improvements in technology, current levels of PPE, the firm's unit growth rates, and which divisions or reportable segments are consuming cash. Are the investments in those segments appropriate in relation to their ability to produce free cash flow? Has outsourcing of production had its intended effect, resulting in capital savings, or has it created additional problems?

² Capital payments on debt instruments in which the firm invested are also considered cash inflows from investing activities; these are, in effect, disinvesting activities. However, interest payments on such debt are classified as operating cash inflows.

A significant increase in the sale of PPE may indicate that the firm is suffering from a cash shortage and decides to generate cash by selling fixed assets. This strategy means that the firm is reducing the scale of operations or that it is gradually liquidating. However, the firm just may be selling underutilized capital or making a strategic shift in its business, such as outsourcing or purchasing more productive capital. Thus the cash-flow analyst will examine these events carefully because of the implications for future cash flows. As we will also see, overspending is also a red flag indicative of mismanagement in the form of wasteful resources.

The firm has three major options in its future expansion: (1) to expand internally through further investments in capital expenditures, (2) to invest in the existing operations of other firms through acquisitions, or (3) to use other firms' capital resources. Most studies to date show that, on average, it is detrimental for a firm to expand through acquisition of other firms; most such acquisitions do not work as originally intended.³ It has been estimated by management consultants that about half the business combinations either fail or fall short of expectations. Thus the cash-flow analyst may want to assess the probability of success for an acquisition and the related costs of that acquisitions in terms of additional debt that is assumed or issued. The analyst also should assess the potential synergies that can be created through acquisition. These may have favorable effects on future cash flows by eliminating redundant operations.

Finally, the cash-flow analyst should examine additional investments in unconsolidated subsidiaries (which are subsidiaries in which the firm owns less than 50 percent of the stock), investments in joint ventures, and investments in other financial instruments. The analyst should carefully assess potential future cash-flow consequences of such investments. Usually, investments in other entities, where the investing firm does not control the investee, are considered less desirable (unless there are debt consequences) than investments in entities where the firm has full control. Similarly, the analyst should examine the reasons for investments in financial instruments; are these made merely to park cash that will be needed in the near future for investments, because of regulatory requirements or because of covenants, or are they made because the firm has no superior investment opportunities?

Sometimes the distinction between investing and operating cash flows is not clearcut. For example, a cash payment may pertain to an item that could be considered either as inventory or as a productive asset. If so, the appropriate classification should depend on the activity that is likely to be the predominant source of cash flows for the item. For example, the acquisition and sale of equipment to be used by the enterprise or rented to others is generally considered an investing

³ The list of failed corporate mergers grows daily. Some of the more notable examples include AT&T/NCR, Sterling Drug/Kodak, AOL/Time Warner, Daimler Benz/Chrysler, HP/Compaq, and Alcatel/Lucent.

activity. However, equipment sometimes is acquired or produced to be used by the enterprise or rented to others for a short period of time and then sold. In such circumstances, the acquisition or production and subsequent sale of those assets can be considered an operating activity.

Needless to say, this ambiguity in reporting requirements leads to different interpretations in practice by many firms. Some leasing companies include the collections of principal on their capital leases as cash flows from operating activities on the grounds that the equipment leased is in fact inventory. Other leasing entities include such payments in investing activities on the grounds that the leases represent investments in the traditional sense. Thus the cash-flow analyst needs to carefully assess the classification of such items as a proper investing or operating cash flow. For example, Bally Technologies and IGT Corp. are two slot-machine manufacturers. When building machines for lease to casinos, Bally's purchase of parts is reported as an operating activity, yet IGT reports the event as an investing activity. When making adjustments to cash flow from operations, the analyst should consider both events as operating cash flows.

Similarly, the analyst should examine the implications of disinvesting events as carefully as investing events. Also, the cash-flow analyst should note that the current requirements of SFAS 95 are that *only* the cash portion of these events is disclosed in the statement of cash flows. It is reasonable in most cases to focus not only on the cash portion of the transaction but also on the noncash portion because of its future consequences. For example, the sale of a division for cash, notes receivable, and stocks likely will yield future cash inflows. During 2008, Prudential Insurance agreed to sell its retail brokerage unit to Wells Fargo, with Prudential receiving \$4.5 billion in cash, but not until January 2010. These payments, to the extent they are probable, should be incorporated by the cash-flow analyst, as well as the initial payment of cash from the sale of the division, which was reported in the statement of cash flows during 2008. During 2010, the \$4.5 billion was received.

Let us now examine several examples of investing activities.

Example:

Merck & Co., Inc., is a global pharmaceutical company. The following schedule is taken from its 2008 10K:

Merck considers the pledge of assets backing up letters of credit to be restricted assets. These restricted assets evolved with a large legal settlement relating to a drug which was sold by Merck and was withdrawn from the market. As the letter of credit amount declines with payment under the Agreement, so too will the restricted assets (shown as "Other assets" on Merck's balance sheet) and reported in its statement of cash flows as the sale of securities shown under investment activities.

	2008	2007	2006
Cash Flows from Investing Activities			
Capital expenditures	(1,298.3)	(1,011.0)	(980.2)
Purchases of securities and other investments	(11,967.3)	(10,132.7)	(19,591.3)
Proceeds from sales of securities and other investments	11,065.8	10,860.2	16,143.8
Acquisitions of subsidiaries, net of cash acquired	—	(1,135.9)	(404.9)
Distribution from AstraZeneca LP	1,899.3	—	—
Increase in restricted assets	(1,629.7)	(1,401.1)	(48.1)
Other	95.8	10.5	(3.0)
Net cash used by investing activities	(1,834.4)	(2,810.0)	(4,883.7)

Example:

In June of 2008, Verizon Corp. paid \$5.9 billion in cash plus the assumption of \$22.2 billion in debt, net of cash acquired, to acquire Alltel Corporation. Immediately prior to the closing, Verizon borrowed \$12.4 billion to complete the acquisition and repay a portion of the Alltel debt. In connection with the borrowings, Verizon entered into swap (hedging) contracts to protect against interest-rate and currency movements because some of this new debt was denominated in pound sterling and euros. In December 2008, additional borrowings were needed.

Verizon also repaid debt totaling \$4.1 billion during the year and repurchased \$1.4 billion of its stock. It is not unusual for boards of directors to “send a signal” to the financial markets on announcement of a large business combination. That signal is designed to show investors that the board is confident that the merger will add to the value of the enterprise and that the board is willing to risk additional capital as a show of faith. This is not a recommended strategy because normally arbitrageurs will offset the stock buyback and investors will wait to see if the combined company does produce the anticipated free cash flows. In Verizon’s case, its stock fell on the announcement and had not recovered 2 years later.

Shown below is the financing section of the balance sheet for Verizon Corp. for fiscal years 2006–2008.

	2008	2007	2006
Cash Flows from Financing Activities			
Proceeds from long-term borrowings	21,598	3,402	3,983
Repayments of long-term borrowings and capital lease obligations	(4,146)	(5,503)	(11,233)
Increase (decrease) in short-term obligations, excluding current maturities	2,389	(3,252)	7,944
Dividends paid	(4,994)	(4,773)	(4,719)
Proceeds from sale of common stock	16	1,274	174
Purchase of common stock for treasury	(1,368)	(2,843)	(1,700)
Other, net	93	(2)	(201)
Net cash provided by (used in) financing activities—continuing operations	13,588	(11,697)	(5,752)
Net cash used in financing activities—discontinued operations	—	—	(279)
Net cash provided by (used in) financing activities	13,588	(11,697)	(6,031)

Example:

Clayton Williams Energy, Inc., is an independent oil and gas company engaged in the exploration and production of oil and natural gas primarily in Texas, Louisiana, and New Mexico. Shown below is the company's entire consolidated statement of cash flows to illustrate its accounting of derivatives, which the company uses to mitigate the risk of falling energy prices. How the derivatives are set up determines whether they are characterized as cash-flow hedges or non-cash-flow hedges (defined in Chapter 6). This is an example of certain hedges not working out, as well as a pitfall of a business acquisition.

During 2004, Clayton made an acquisition of another energy company that had put in place derivative contracts having a price of \$28 a barrel, meaning that a rise in the price of a barrel of crude above \$28 would result in a loss as the contracts were settled. As those contracts reached expiration, they indeed saddled Clayton with a huge loss as the price of crude ran up. Fortunately for Clayton, though, it had other hedges in place that were quite profitable.

In its year-end 2009 income statement, the company booked a gain of \$74.7 million, with that amount a sum of both realized and unrealized gains for the year. We see \$49.7 million of "unrealized gains" reversed under operating cash flows. Therefore, the company had a cash realizable gain for the year approximating \$25 million.

The company also shows \$43.486 million under financing cash flows, representing cash that was paid to counterparties to settle hedged contracts. Under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, because the contracts Clayton acquired pursuant to the merger agreement did not meet the requirement of a cash-flow hedge, those contracts are characterized as non-cash-flow hedges and must be presented under financing activities. If they were cash-flow hedges, under SFAS 133, they would be recognized in "Other comprehensive income" until the hedged item is recognized in earnings. If they are not recognized as cash-flow hedges, they are recognized in earnings, as reported by Clayton Williams.

How did Clayton do on its hedged contracts during 2008?

	Amount
From income statement	\$74,743
Add: Unrealized—from operating activities	<u>(49,738)</u>
Equals: Realized gains	25,005
Less: Settled losses—from financing activities	<u>43,486</u>
Normal hedged gains	68,491

Thus Clayton took in \$68.491 million on normal hedged activities, from which it had cash payments of \$43.486 million, which more than cover the loss-ridden contracts taken on by the acquisition.

Because settlements on derivative contracts deemed to contain a financing element are reported as financing activities in the statement of cash flows and must be reversed under operating activities (the loss is already taken into account in the income statement), it has the effect of increasing (decreasing with a gain) cash flow from operations. This can under certain circumstances, such as not merely reversing an item in the income statement, result in over(under)stated operating cash flows to analysts who use a simple definition of free cash flow

defined as either operating cash flow minus depreciation or an EBIDTA-based definition. One therefore must inspect for such reversals if the hedge is deemed a noncash hedge.

Companies that use derivative contracts as partial speculation should be accorded a higher cost of capital. It is not a coincidence, therefore, that Clayton Williams has greater volatility of free cash flow and tax rate, although an inspection of its tax footnote reveals that the latter is due in part to the tax incentives.

CLAYTON WILLIAMS ENERGY, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year Ended December 31,		
	2008	2007	2006
Cash flows from operating activities			
Net income	\$140,534	\$5,990	\$17,799
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation, depletion, and amortization	120,542	84,476	66,163
Impairment of property and equipment	12,882	12,137	21,848
Exploration costs	80,112	68,870	65,173
Gain on sales of property and equipment, net	(42,381)	(4,209)	(1,668)
Deferred income taxes	77,327	3,768	215
Noncash employee compensation	5,834	1,865	2,279
Unrealized (gain) loss on derivatives	(49,738)	24,249	(57,568)
Settlements on derivatives with financing elements	43,486	28,468	29,407
Amortization of debt issue costs	1,354	1,281	1,308
Accretion of abandonment obligations	2,355	2,508	1,653
Excess tax benefit on exercise of stock options	—	(963)	(1,807)
Minority interest, net of tax	708	3,812	574
Changes in operating working capital:			
Accounts receivable	13,087	(10,028)	(8,101)
Accounts payable	(4,946)	10,992	3,543
Other	(19,176)	1,650	5,172
Net cash provided by operating activities	<u>381,980</u>	<u>234,866</u>	<u>145,990</u>
Cash flows from investing activities			
Additions to property and equipment	(350,106)	(233,453)	(254,840)
Additions to equipment of Larclay JV	(1,683)	(29,302)	(60,655)
Proceeds from sales of property and equipment	117,226	22,773	4,451
Change in equipment inventory	(8,247)	18,166	(662)
Other	3,935	(14,443)	1,753
Net cash used in investing activities	<u>(238,875)</u>	<u>(236,259)</u>	<u>(309,953)</u>

	Year Ended December 31,		
	2008	2007	2006
Cash flows from financing activities			
Proceeds from long-term debt	—	25,800	129,300
Proceeds from long-term debt of Larclay JV	7,500	8,727	66,254
Repayments of long-term debt	(71,700)	—	—
Repayments of long-term debt of Larclay JV	(22,500)	(13,125)	—
Proceeds from sale of common stock	15,936	6,000	3,914
Settlements on derivatives with financing elements	(43,486)	(28,468)	(29,407)
Excess tax benefit on exercise of stock options	—	963	1,807
Net cash provided by (used in) financing activities	<u>(114,250)</u>	<u>(103)</u>	<u>171,868</u>
Net increase (decrease) in cash and cash equivalents	28,855	(1,496)	7,905
Cash and cash equivalents			
Beginning of period	12,344	13,840	5,935
End of period	<u>\$41,199</u>	<u>\$12,344</u>	<u>\$13,840</u>
Supplemental disclosures			
Cash paid for interest, net of amounts capitalized	<u>\$24,027</u>	<u>\$35,213</u>	<u>\$19,653</u>
Cash paid for income taxes	<u>\$16,652</u>	<u>\$348</u>	<u>\$196</u>

Example:

Black and Decker reported the following investing cash flows in its 2008 10K:

	2008	2007	2006
Investing Activities			
Capital expenditures	(98.8)	(116.4)	(104.6)
Proceeds from disposal of assets	20.4	13.0	14.7
Purchase of businesses, net of cash acquired	(25.7)	—	(158.5)
Reduction in purchase price of previously acquired business	—	—	16.1
Cash inflow from hedging activities	72.4	2.0	1.4
Cash outflow from hedging activities	(29.7)	(47.4)	(14.8)
Other investing activities, net	—	(1.0)	4.7
Cash flow from investing activities	(61.4)	(149.8)	(241.0)

As is typical, the largest item in the subsection of investment activities is capital expenditures, which we discuss in relation to excessive expenditures (corporate "fat") in Chapter 4. The company also disposed of assets as well as made a small acquisition. The company uses derivatives in its hedging activities as protection against changes in commodity prices, in addition to interest-rate hedging on its variable-rate debt. One may question whether commodity price hedging is more suitably related to an operating activity, as are its other related input costs. Over the 3 years shown, the hedges have resulted in a \$16.1 million outflow, rather insignificant for a company having over \$6 billion in revenues and \$1.5 billion in balance-sheet debt.

Example:

Accuray, Inc., develops and manufactures robots used in medical procedures, which the company calls the CyberKnife system. In the sales process, customer's deposits are backed with a letter of credit. As the letters of credit are released, so too are the deposited funds.

During 2009, the company's decrease in restricted cash results from releases of deposited funds as delivery of the CyberKnife unit takes place. Accuray's balance sheet showed that restricted cash declined from \$4,830 to \$527, or a \$4,303 difference, shown under investment activities. Some entities report a change in restricted cash as a financing activity, so the analyst should ensure comparability.

	2009	2008	2007
Cash flows from investing activities			
Purchases of property and equipment	(4,232)	(5,030)	(7,230)
Restricted cash	4,303	(4,830)	1
Purchase of investments	(155,934)	(177,651)	(283)
Sale and maturity of investments	157,732	54,089	—
Net cash provided by (used in) investing activities	1,869	(133,422)	(7,512)

Source: Accuray 2009 10K.

Example:

Phelps Dodge is one of the world's leading producers of copper and molybdenum and is the world's largest producer of molybdenum-based chemicals and continuous copper rod. Its investment activities reveal several entries that bear interest. The first is the reversal of capitalized interest, which appears on the balance sheet as an asset but actually represents a cash expenditure; thus the cash effect is reported in that section. Also reported are \$300 million in expenditures during 2006 and \$100 million during 2005, representing cash contributions of those amounts into a trust fund earmarked for environmental and mine-closure regulatory compliance. The analyst must inquire how these contributions will be financed, the estimated total obligation, any possible future claims, and the extent of insurance.⁴

Phelps Dodge ramped up its capital expenditure program during 2006. The \$1.2 billion in cash expenditures was partially offset by \$641 in asset sales, with the balance financed via the large cash flow from company operations.

Also in the investment activities section is \$12.1 million of "Other investing, net." This could represent a new investment or an addition to an old investment. The analyst would need further clarification from the company to learn the nature of the outlay(s).

⁴ BP PLC was self-insured, having set up insurance subsidiary companies, according to its 20-F. As soon as the oil rig explosion in the Gulf of Mexico occurred, it was incumbent on the analyst to place a worst case outcome scenario. The insurance sub had its parent covered up to \$1 billion per incident. In its SEC filings, BP wrote prior to the disaster it considers "external insurance as not being an economic means of financing losses."

Regarding capital expenditures, there is no reason to believe that it must be *consistently* below cash flow from operations. Over the operating cycle, such must be the case because sooner or later the entity will confront a business downturn, and if the gap were continually debt financed, this could place the firm in a severe strain.

However, if the entity is conservatively financed and capable of investing in projects having a higher return on invested capital than its cost, the capital expenditure gap will prove to be value-adding and will reward shareholders over time. It is the divisions that are capital-intensive and do not generate free cash flow and returns on invested capital greater than their cost that should be scrutinized with an eye on disposal. Balance-sheet cash and financial flexibility have a calculable strategic value and so must be put to use properly. When this advantage becomes minimized, the entity's ability to take on additional value-enhancing projects becomes impaired.

Investing Activities	2006	2005	2004
Capital outlays	(1,191.1)	(686.0)	(303.6)
Capitalized interest	(54.4)	(17.6)	(1.0)
Investments in subsidiaries and other, net of cash received	3.3	(12.2)	(13.7)
Proceeds from the sale of Columbian Chemicals	505.2	—	—
Proceeds from the sale of Magnet Wire North American assets	136.5	—	—
Proceeds from the sale of High Performance Conductors	47.9	—	—
Proceeds from sale of cost-basis investments, net of expenses	—	451.6	—
Proceeds from other asset dispositions	25.1	18.2	26.9
Restricted cash	(4.6)	(20.8)	—
Global reclamation and remediation trust contributions	(300.0)	(100.0)	—
Other investing, net	(12.1)	(1.2)	0.4
Net cash used in investing activities	(844.2)	(368.0)	(291.0)

Source: Phelps Dodge 2006 10K.

Example:

Chevron, the large integrated energy company, explains in a footnote the sizable capitalization of items representing cash spent but placed on the balance sheet as an asset. These include expenses related to exploration activities that may be accounted for, under generally accepted accounting principles (GAAP), using two methods: full cost or successful efforts.

Under successful-methods reporting, a firm expenses the costs of unsuccessful drilling and exploration costs, such as geologic and geophysical expenditures, engineering expenses, and the costs of carrying and retaining undeveloped properties.

Under the successful-efforts method, only exploratory drilling costs that result in the discovery and development of a commercial oil and gas field may be capitalized and amortized based on the field's proven reserves on a unit-of-production basis; all expenditures that are unsuccessful (dry holes) are expensed as incurred. Using the full-cost accounting method, all exploration

and development expenditures are capitalized and amortized over the reserves of the related pool of properties.

The following is from Chevron's 2009 10K, where dry-hole expense is shown under operating activities.

Properties, Plant, and Equipment The successful efforts method is used for crude oil and natural gas exploration and production activities. All costs for development wells, related plant and equipment, proved mineral interests in crude oil and natural gas properties, and related asset retirement obligation (ARO) assets are capitalized. Costs of exploratory wells are capitalized pending determination of whether the wells found proved reserves. Costs of wells that are assigned proved reserves remain capitalized. Costs also are capitalized for exploratory wells that have found crude oil and natural gas reserves even if the reserves cannot be classified as proved when the drilling is completed, provided the exploratory well has found a sufficient quantity of reserves to justify its completion as a producing well and the company is making sufficient progress assessing the reserves and the economic and operating viability of the project. All other exploratory wells and costs are expensed.

	Year ended December 31,		
	2008	2007	2006
Operating activities			
Net income	\$23,931	\$18,688	\$17,138
Adjustments			
Depreciation, depletion, and amortization	9,528	8,708	7,506
Dry-hole expense	375	507	520
Distributions less than income from equity affiliates	(440)	(1,439)	(979)
Net before-tax gains on asset retirements and sales	(1,358)	(2,315)	(229)
Net foreign currency effects	(355)	378	259
Deferred income tax provision	598	261	614
Net (increase) decrease in operating working capital	(1,673)	685	1,044
Minority interest in net income	100	107	70
Increase in long-term receivables	(161)	(82)	(900)
(Increase) decrease in other deferred charges	(84)	(530)	232
Cash contributions to employee pension plans	(839)	(317)	(449)
Other	10	326	(503)
Net cash provided by operating activities	29,632	24,977	24,323
Investing activities			
Capital expenditures	(19,666)	(16,678)	(13,813)
Repayment of loans by equity affiliates	179	21	463
Proceeds from asset sales	1,491	3,338	989
Net sales of marketable securities	483	185	142
Net sales (purchases) of other short-term investments	432	(799)	—
Net cash used for investing activities	(17,081)	(13,933)	(12,219)

Example:

Overseas Shipholding Group is one of the world's leading bulk shipping companies, engaged primarily in the ocean transportation of crude oil and petroleum products. The unusual entry found under investing activities relates to the "Capital construction fund." To encourage private investment in U.S. metric vessels, the Merchant Marine Act of 1970 permits deferral of taxes on earnings from U.S. metric vessels deposited into a capital construction fund and amounts earned thereon, which can be used for the construction or acquisition of or retirement of debt on qualified U.S. metric vessels (primarily those limited to foreign, Great Lakes, and noncontiguous domestic trades).

Overseas Shipholding was using funds in its capital construction fund for business acquisitions (which included ships covered under the act), as well as the original construction of new vessels.

In another such maneuver, during the 1980s, Harold Simmons, a well-known corporate raider, made an unsolicited takeover offer for Sea-Land Corporation, with the motivating factor the cash in Sea-Land's large capital construction fund. Mr. Simmons believed that he would be able to use the cash in the fund for purposes other than that specified in the Merchant Marine Act, presumably to make other corporate acquisitions outside the industry. Eventually, CSX Corp. purchased Sea-Land and in the process paid a healthy premium to its shareholders, including Mr. Simmons.

The following is from the Overseas Shipholding's 2008 10K.

	2008	2007	2006
Cash flows from investing activities			
Purchases of marketable securities	(15,112)	—	—
Proceeds from sale of marketable securities	7,208	—	—
Expenditures for vessels, including \$313,045 in 2008, \$260,716 in 2007, and \$48,100 in 2006 related to vessels under construction	(608,271)	(545,078)	(55,793)
Withdrawals from Capital Construction Fund	105,700	175,950	—
Proceeds from disposal of vessels	461,872	224,019	258,877
Acquisition of Heidmar Lightering, net of cash acquired of \$2,600	—	(38,471)	—
Acquisition of Maritrans, Inc., net of cash acquired of \$24,536	—	—	(444,550)
Expenditures for other property	(10,809)	(15,864)	(11,591)
Investments in and advances to affiliated companies	(37,871)	(31,083)	(8,613)
Proceeds from disposal of investments in affiliated companies	—	194,706	—
Distributions from affiliated companies	20,148	—	4,772
Other, net	113	926	196
Net cash used in investing activities	(77,022)	(34,895)	(256,702)

Example:

Toll Brothers, Inc., is in the business of designing, building, and marketing homes and rental apartments. Toll has investments in and makes advances to a number of joint ventures with unrelated parties to develop land, either for sale or on which to build. It accounts for these investments under the equity method at \$152 million on its balance sheet.

Toll also guarantees the debt of several of its unconsolidated subsidiaries, which as of October, 31, 2009, amounted to \$63.3 million. These subsidiaries, according to Toll's 2009 10K, had net borrowings of \$850 million that are not consolidated on Toll's balance sheet. Toll also shows \$54 million of accrued expenses on its balance sheet to the unconsolidated entities.

These investments and guarantees represent an integral part of the security analysis, given the size of the liabilities and Toll's higher-than-average cost of capital. Although a small percentage of the unconsolidated subsidiaries' total liabilities are guaranteed, there may be some moral commitments involved, especially if Toll has dealings outside the unconsolidated subsidiaries with their creditors.

	2008	2007	2006
Cash flow (used in) provided by investing activities:			
Purchase of property and equipment, net	(2,712)	(8,158)	(14,975)
Proceeds from sale of ancillary businesses			32,299
Purchase of marketable securities	(101,324)	(1,468,440)	(5,769,805)
Sale of marketable securities		1,463,487	5,769,805
Investment in and advances to unconsolidated entities	(31,342)	(54,787)	(34,530)
Return of investments in unconsolidated entities	3,205	3,268	42,790
Net cash (used in) provided by investing activities	(132,173)	(64,630)	25,584

Source: Toll Brother's 2009 10K.

Example:

Central Iowa Energy, LLC, is in the business of developing and constructing biodiesel plants. The company recorded, in its 2009 10K, a sales tax refund as an investment activity because the transaction that gave rise to that cash inflow was an investment activity, the purchase of equipment. The cost of the asset was depreciated at the net amount and is classified properly. A tax refund due to an operating loss would be classified as an operating activity.

	2009	2008
Cash flows from investing activities:		
Capital expenditures	(43,190)	(76,688)
Sales tax refund from equipment purchases	—	461,517
Increase in restricted cash	(460,188)	—
Net cash provided by (used in) investing activities	(503,378)	384,829

Example:

As an insurance firm, the Travelers Corp. makes investments in financial assets, out of which it pays its claims. The financial assets include securities with fixed maturities, mortgage loans, equity securities, and investments in real estate. The items on the portion of the cash-flow statement that relate to investing activities usually describe these financial investments or the collections of principal on these investments. However, one of the items in the list is securities transactions in course of settlement, which represents additional investments in securities where cash was used to purchase certain financial instruments but where the financial instruments were not yet the property of the firm on the balance-sheet date. It also represents financial instruments that were lent to other business entities and were not available for use by the Travelers as of the balance-sheet date. Thus it properly represents a cash flow from an investing activity and not a cash flow resulting from operating activity. The following is from Traveler's 2008 10K:

	2008	2007	2006
Cash flows from investing activities			
Proceeds from maturities of fixed maturities	4,869	5,305	5,810
Proceeds from sales of investments:			
Fixed maturities	6,932	7,323	4,401
Equity securities	53	106	285
Real estate	25	11	—
Other investments	655	1,460	1,111
Purchases of investments:			
Fixed maturities	(11,127)	(14,719)	(13,845)
Equity securities	(95)	(135)	(83)
Real estate	(38)	(74)	(75)
Other investments	(667)	(740)	(705)
Net (purchases) sales of short-term securities	(406)	(562)	(85)
Securities transactions in course of settlement	(318)	(123)	447
Other	(45)	(378)	(325)

Example:

W. R. Grace & Co. is engaged in the production and sale of specialty chemicals and specialty materials on a global basis through its two operating segments. Grace, along with 61 of its U.S. subsidiaries and affiliates, filed voluntary petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code and, since 2001, has been subject to the jurisdiction of the U.S. Bankruptcy Court for the District of Delaware.

Grace terminated (surrender value) life insurance policies of its executives to raise cash. One might argue that this is better represented as a financing activity. The proceeds were used to fund the potentially large liabilities and awards related to asbestos claims against the company.

As we will see in a later chapter, lawsuits and the potential for large damage awards have a vitriolic effect on the cost of capital. Shareholders of Grace can understand why this is so. Seen below is the investment activities section taken from the W. R. Grace 2009 10K.

	2009	2008
Investing activities:		
Capital expenditures	(36.5)	(58.7)
Proceeds from sales of investment securities	8.3	46.7
Purchases of equity investments	(1.0)	(3.0)
Proceeds from termination of life insurance policies	68.8	8.1
Net investment in life insurance policies	(0.4)	0.1
Proceeds from disposals of assets	5.4	2.6
Net cash provided by (used for) investing activities	44.6	(4.2)

Example:

Martek Biosciences Corporation develops nutritional products using microbes such as algae and fungi. In its 2009 10K, the company capitalized a variety of expenses, including significant legal costs (amortized over 5 years) and patent and interest expenses related to projects under construction.

The cash-flow analyst should view the capitalization of interest expenses no differently than interest expense paid on debt running through the income statement. As such, capitalized interest on plant and legal should have been included as operating activities, and to the extent they are listed as an investing activity, operating cash flows are artificially boosted.

The decision as to whether or not to capitalize certain cash outflows allows wide management discretion, potentially distorting peer comparability.

	2009	2008	2007
Investing activities:			
Sales and maturities of investments	200	8,475	6,850
Purchases of investments	—	(16,925)	(275)
Expenditures for property, plant, and equipment	(8,932)	(9,785)	(8,279)
Repurchase from sale-leaseback transaction and other	—	—	(3,010)
Capitalization of intangible and other assets	(18,535)	(3,895)	(6,010)
Net cash used in investing activities	(27,267)	(22,130)	(10,724)

Example:

Jackson Hewitt Tax Service, Inc., provides computerized preparation of federal, state, and local individual income tax returns in the United States through a nationwide network of franchised and company-owned offices operating under the brand name Jackson Hewitt Tax Service. While the company has had a history of adequate cash-flow generation, a caveat is detected in the investment activity section of its 2009 10K, "Funding provided to franchisees." While Jackson Hewitt reports on its balance sheet less than 5 percent of its shareholders' equity in the form of notes receivable, many companies, such as Krispy Kreme, have failed to do so owing to their financing the operations of franchisees. Many franchisors have had to take back the retail locations of its failed franchises having deficit cash flows, resulting in the firm having greater total operating leases (debt) while absorbing much management time. Such companies include Burger King, Midas, Sharper Image, and Nathan's Famous.

As to be discussed in Chapter 8, Jackson Hewitt relied on a single bank lending program for much of its cash flows. Such reliance on a customer or supplier for an important part of business

success will raise risk (cost of equity capital). When that program was ended by its bank, shares in Jackson Hewitt stock fell rather dramatically.

	2009	2008	2007
Investing activities:			
Capital expenditures	(7,603)	(6,441)	(8,949)
Funding provided to franchisees	(6,550)	(9,364)	(6,489)
Proceeds from repayments by franchisees	2,271	2,426	2,133
Cash paid for acquisitions	(14,504)	(17,669)	(3,828)
Net cash used in investing activities	(26,386)	(31,048)	(17,133)

Example:

Cree, Inc., develops and manufactures semiconductor materials and devices based primarily on silicon carbide, gallium nitride, and related compounds. There are several items of interest in the investment activity section of its 2008 10K. As reported, Cree has been an active acquirer both of capital and of intangible assets. The largest items in the section represent the purchase and sale of fixed-income investments, which is common for entities that have either raised funds, sold assets, or are steady free-cash-flow generators. As seen below, fewer of these investments matured during the most recent fiscal year, which, relative to the prior year, was the difference in the investments being able to provide cash for the company's acquisitions. You also can see a \$60 million payment related to the acquisition of COTCO 2 years earlier. Cree achieved certain EBITA targets related to the acquisition and was obligated to make the payment to the former shareholder. The cash payment represents an addition to the purchase price and a commensurate addition to goodwill on its balance sheet and is an event the analyst should have been aware of. Analysts will model for any such payments in their projected statement of cash flows, having been aware of deal terms.

	2008	2007	2006
Cash flows from investing activities:			
Purchase of property and equipment	(55,283)	(55,741)	(82,604)
Purchase of Intrinsic Semiconductor Corporation, net of cash acquired	—	—	(43,850)
Purchase of COTCO Luminant Devices, Ltd., net of cash acquired	—	—	(79,289)
Purchase of LED Lighting Fixtures, Inc., net of cash acquired	—	(7,180)	—
Payment of COTCO contingent consideration	(60,000)	—	—
Payment of LLF contingent consideration	(4,386)	—	—
Purchase of investments	(217,059)	(413,735)	(167,608)
Proceeds from maturities of investments	134,561	507,091	254,840
Proceeds from sale of property and equipment	169	1,465	550
Proceeds from sale of available-for-sale investments	35,815	17,000	26,646
Purchase of patent and licensing rights	(8,660)	(7,647)	(6,399)
Net cash (used in) provided by investing activities	(174,843)	41,253	(97,714)

Example:

ConAgra Foods, Inc., is a leading food distributor. ConAgra has a strong business-to-business presence, supplying potato, other vegetable, spice, and grain products to a variety of well-known restaurants, food-service operators, and commercial customers. ConAgra, in its 2009 10K, reports that it purchased businesses totaling \$84 million that was financed in part by the sale of businesses for which it accounted using the equity method. For 2008 and 2007, ConAgra also reports both the purchase of and sale of leased warehouses. ConAgra leases warehouses for its manufacturing, storage, and distribution operations. While, from the investing activity section, we see ConAgra has not been successful in buying and selling warehouses, one would need to know the rental (and tax) savings, if any, ConAgra was able to effect by owning those properties. One may question whether the buying and selling of warehouses more appropriately might be suited as an operating activity because there were quite a few transactions relating to the ongoing nature of those transactions. Placing these transactions into operating activities would have reduced operating cash flow and, in any event, requires further insight from the company related to this business strategy.

	2009	2008	2007
Cash flows from investing activities:			
Purchase of marketable securities	—	(1,351.0)	(4,075.5)
Sales of marketable securities	—	1,352.0	4,078.4
Additions to property, plant, and equipment	(441.9)	(449.6)	(386.1)
Purchase of leased warehouses	—	(39.2)	(93.6)
Sale of leased warehouses	—	35.6	91.6
Sale of investment in Swift note receivable	—	—	117.4
Sale of businesses and equity-method investments	29.7	—	73.6
Sale of property, plant, and equipment	27.1	30.0	74.3
Purchase of businesses and intangible assets	(84.2)	(255.2)	—
Other items	1.9	1.5	11.2
Net cash flows from investing activities—continuing operations	(467.4)	(675.9)	(108.7)
Net cash flows from investing activities—discontinued operations	2,258.6	32.1	631.6
Net cash flows from investing activities	1,791.2	(643.8)	522.9

CASH FLOWS FROM FINANCING ACTIVITIES

The FASB defines financing activities broadly as follows:

Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit [SFAS 95, para. 18].

The FASB further clarifies the nature of cash inflows or cash outflows from financing activities in the following manner:

Cash inflows from financing activities are

- a. Proceeds from issuing equity instruments.
- b. Proceeds from issuing bonds, mortgages, notes, and other short- or long-term borrowing.

Cash outflows for financing activities are

- a. Payments of dividends or other distributions to owners, including
- b. Outlays to reacquire the enterprise's equity instruments.
- c. Repayments of amounts borrowed.
- d. Other principal payments to creditors who have extended long-term credit [SFAS 95, paras. 19–20].

Financing activities are cash transactions that involve liabilities or shareholders' equity. The logic underlying the definition of financing activities seems very clear: All the events that represent increases of internal or external capital are financing cash flows, whereas events that represent decreases of internal or external capital are disfinancing cash flows. Loosely speaking, internal capital is capital invested by shareholders in the firm, whereas external capital represents lending to the firm by creditors.

Cash flows from financing activities first should be segregated into cash inflows and cash outflows from financing activities. The net cash flows from financing activities will be determined by the net cash generated from operating activities minus the net cash used for investing activities minus the increase in the cash balance. Thus, once the cash-flow analyst examines the cash generated from operations and cash investments, net cash financing is of little relevance. However, the composition of net cash from financing activities is of great relevance.

The most significant source of financing for most firms is borrowing. The academic literature is unclear about the implications of debt financing. Debt financing generally is considered favorable because interest on debt is tax deductible; that is, no tax is due on profits paid to creditors. The same argument is extended for return on invested capital; that is, return on invested capital is enhanced through borrowing. However, a firm that is overly leveraged increases the risk of bankruptcy and thus the expected costs of bankruptcy to shareholders, including total loss of their investment. Since debt payments and interest cannot be met from an accounting concept, I rely on the ability of the entity to produce cash. To the extent that cash from operations and disinvesting activities is insufficient to satisfy obligations, financial officers will turn to financial activities.

Many potential business acquisitions are approved or disapproved by the ease with which the free cash flow of the new asset can pay down the incremental debt. To the extent that it takes longer to repay debt from cash flows, the attractiveness of the company to potential acquirers is mitigated.

Most firms have some optimal level of debt; increases beyond this level are undesirable for the firm, whereas increases up to that point could be favorable. Some fortunate firms are such strong cash-flow producers that investment opportunities are easily financed through internal operations. The cash-flow analyst may wish to consider whether the firm's increase in debt financing is favorable or not depending on the analyst's assessment of the optimal level of debt in relation to the firm's pro forma ability to meet scheduled debt payments from a conservative cash-flow forecast. The cost of debt will also be compared to the expected after-tax cash return (its free cash flow) of a particular project.

Another implication of debt financing is that current owners/shareholders of the firm indicate that they wish to retain full ownership in the firm, possibly because they perceive a high probability that the value of the firm will grow or the current market value does not fully recognize the entity's real value. Thus, increases in debt financing or, at least, increases in debt financing that are not accompanied by increases in equity financing may be perceived as favorable signals about the future prospects of a firm. However, increases in debt financing may cause conflicts of interest between stockholders and bondholders, which, in turn, may lead management to invest in suboptimal projects. This arises when equity holders are beholden to creditors, and are in fact fearful a mis-step of an investment would place bondholders in control through bankruptcy. Such conflicts may lead to undesirable consequences or to wasted resources that are dedicated to reducing this conflict. Thus, issuance of debt sometimes may be viewed negatively by the cash-flow analyst.

One important asymmetry in the treatment of internal and external capital under SFAS 95 should be highlighted at this point: Dividends paid to shareholders are classified as financing cash outflows because they represent disfinancing events. However, payments of interest on a loan do not represent cash outflows from financing activities; instead, as we shall see in the next section, they represent an operating cash outflow. This is an asymmetric treatment because both represent a return on capital to providers, and there should not be any distinction between a return to creditors and a return to shareholders. The inclusion of interest payments among operating cash flows will bias the concept of cash flows generated from ongoing operations and the concept of free cash flow as it is generally defined. Therefore, interest, dividends, and tax cash flows that have been reported as financing or investing activities may be moved to operating activities to avoid distortion and improve comparability. On adjustment, misclassifications do not affect the free-cash-flow definition I propose in Chapter 4, with further clarification in Chapter 8 as to the cost-of-capital effect.

Let me provide now examples of financing cash flows from the statement of cash flows.

Example:

The following is taken from US Precious Metal's, 2009 10K. It is an exploration-stage company engaged in the acquisition, exploration, and development of mineral properties. The company raised about \$5.3 million in equity capital between 1998 and 2009. Unfortunately, its balance sheet reveals deficit shareholders' equity of \$1.8 million as of May 2009 because it has not yet recorded operating revenue. The company has exhausted its cash resources.

	Year Ended		Exploration Stage
	May 2009	May 2008	Jan 1988–May 2009
Financing activities:			
Proceeds from sales of common stock	400,000	1,417,500	3,492,500
Proceeds from exercises of warrants	184,998	80,000	267,498
Proceeds from convertible notes	730,000	—	730,000
Loan from affiliated company	—	—	70,000
Repayment of loan to the affiliated company	—	—	(68,000)
Cash provided by financing activities	1,314,998	1,497,500	4,491,998

Example:

Harris Corporation, together with its subsidiaries, is an international communications and information technology company serving government and commercial markets in more than 150 countries. From its 2009 10K, we see that Harris assumed borrowings (net of \$450 million) that were used to finance \$745 million in businesses acquired and \$98.7 million for property, plant, and equipment.

Harris also recorded a \$5.6 million inflow in connection with the proceeds of employee stock options. One might question whether this entry is more properly allocated as an operating activity because it is related to salaries needed for the production process.

The management of Harris feels confident in its future prospects, having bought back \$132.3 million of its stock in the same year as the acquisition, of which over half was financed with debt. Normally, if debt financing is needed to fund an acquisition, share buybacks should not be undertaken. An exception would be if the entity is underlevered, the cash yield is low, and the free cash flow resulting from the investment is relatively certain to improve return on invested capital (ROIC).

You also can see that Harris made a \$100 million payment to Harris Stratex Networks as part of the spin-off of this division to its shareholders. A *spin-off* is the distribution of shares of a company owned by the parent to shareholders. Companies may undertake a spin-off if they feel that the value of the division is not being properly reflected in its current market value. Of course, the parent also may attempt to sell the division, and if that is not successful, a spin-off may be pursued.

	2009	2008	2007
Investing activities			
Cash paid for acquired businesses	(745.3)	(19.4)	(404.6)
Cash received in the combination with Stratex Networks, Inc.	—	—	33.1
Additions of property, plant, and equipment	(98.7)	(112.9)	(88.8)
Additions of capitalized software	(23.1)	(33.3)	(40.3)
Cash paid for short-term investments available for sale	(1.2)	(9.3)	(356.0)
Proceeds from the sale of short-term investments available for sale	3.7	26.6	473.7
Proceeds from the sale of securities available for sale	—	13.7	—
Net cash used in investing activities	<u>(864.6)</u>	<u>(134.6)</u>	<u>(382.9)</u>
Financing activities:			
Proceeds from borrowings	531.8	460.5	442.0
Repayment of borrowings	(81.4)	(599.4)	(39.3)
Payment of treasury lock	—	(8.8)	—
Proceeds from exercise of employee stock options	5.6	45.2	35.7
Repurchases of common stock	(132.3)	(234.6)	(251.3)
Cash dividends	(106.6)	(81.5)	(58.2)
Cash decrease related to spin-off of Harris Stratex Networks, Inc.	<u>(100.0)</u>	<u>—</u>	<u>—</u>
Net cash provided by (used in) financing activities	117.1	(418.6)	128.9

Example:

Kaman Corporation is in the aerospace and industrial distribution markets under four reporting segments: aerostructures, precision products, helicopters, and specialty bearings. The windfall profit tax benefits seen in the 2007–2009 financing activity section of its 2009 10K relate to the tax savings resulting from the exercise of nonqualified stock options and disqualifying dispositions of stock acquired by exercise of incentive stock options and employee stock purchase plan stock purchases in excess of the deferred tax asset originally recorded. A windfall tax benefit is created if the deduction for tax purposes exceeds the compensation cost recognized in the income statement. These benefits are reflected under financial activities under FAS 1239(R). Since normally stock compensation is an operating activity, it may be preferable to adjust these benefits to that section because the reporting under financing activity may understate cash flow from operations.

You also will see a book overdraft increase of \$5 million. Book overdraft positions occur when total outstanding issued checks exceed available cash balances.

	2009	2008	2007
Cash flows from financing activities:			
Net borrowings (repayments) under revolving credit agreements	31,636	(45,286)	11,735
Proceeds from issuance of long-term debt	50,000	—	—
Debt repayment	—	(1,722)	(1,821)
Net change in book overdraft	5,003	(4,613)	4,872
Proceeds from exercise of employee stock plans	3,616	5,256	3,238
Dividends paid	(14,181)	(12,552)	(12,002)
Debt issuance costs	(645)	(150)	—
Windfall tax benefit	349	1,171	378

Example:

Briggs & Stratton is the world's largest producer of air-cooled gasoline engines for outdoor power equipment. Reproduced below is the financial activity section from its 2009 10K. The section is fairly straightforward, with cash outlays of approximately \$137 million for dividends and repayment of principal on debt. You also will see \$991,000 in proceeds from stock options and their related tax benefit. Companies receive an expense deduction on their tax returns that is equal to the market price of the shares less the exercise price of the option. I will discuss this at greater length in the following two examples.

	2009	2008	2007	2006	2005
Cash flows from financing activities:					
Net (repayments) borrowings on loans, notes payable, and long-term debt	(92,883)	74,118	8,481	(8,778)	(19,062)
Issuance cost of amended revolver	(1,286)	—	—	—	(1,286)
Cash dividends paid	(43,560)	—	—	—	(43,560)
Capital contributions received	—	383	5,638	(6,021)	—
Stock option exercise proceeds and tax benefits	991	—	—	—	991
Net cash provided (used) by financing activities	(136,738)	74,501	14,119	(14,799)	(62,917)

Example:

The operating and financing activities sections from The Dress Barn's 2009 10K illustrate the reporting of excess tax benefits from stock-based compensation, which, as we have seen, is a commonly used method of cash salary savings and motivation incentive. The basis for recognizing the issuance of stock options as an expense is the value attached to these instruments to both employers and employees. Many employees accept a lower cash salary in return for stock

options, perceiving future stock value in excess of forgone cash compensation. The employer also benefits by preserving cash or using that capital in other areas.

Accounting rules require that excess tax benefits be reported as a financing cash flow rather than a reduction of taxes paid. The income tax effect is related to the expense portion of the stock option transaction and, accordingly, is classified as an operating activity.

Note that in The Dress Barn's statement of cash flows, financing activities, excess tax benefit is the same as found under operating activities but in a different direction (the excess tax benefit is negative under operating activities and positive in financing activities). The cash tax benefit from stock-based compensation typically will be split between operating cash flows and financing cash flows. The "excess" is the difference between what the company estimated and the actual tax benefit. For example, if the firm underbooked, the excess will be positive and is reported in cash flow from financing activities. Hence, for The Dress Barn, the company is moving the excess benefit from an operating activity to a financial activity while continuing to show stock-based compensation expense as an operating activity.

The employer generally is eligible for a tax deduction equal to the full amount of the stock when the employee vests in the restricted stock or the intrinsic value of the stock when the option is exercised. Firms that trade at higher valuation multiples will be accorded a greater tax savings. Under SFAS 123(R), for book purposes, a company generally measures the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. Fair value normally is determined using a Black-Scholes option-valuation model. That cost is amortized over the vesting period. When a restricted stock vests or a non-qualified option is exercised, the amount of the employer's corporate tax deduction is fixed. At that time, it is evident whether the amount deductible on the tax return is greater or less than the cumulative compensation cost amortized over the vesting period. Excess tax benefits, if any, are credited to additional paid-in capital.

Does stock-based compensation artificially boost cash flow from operations? In almost all cases, the answer is yes because although the stock represents real value, to the extent that a peer pays its employees all cash-based compensation, it distorts comparability. However, to deduct the amount (\$6.577 million for The Dress Barn) would result in lower cash flows than actually occurred, with no future cash outlay required, as would be the case of underfunding a pension plan. The cost to existing and future shareholders is that the value of their equity investment is potentially diluted; thus we would not subtract stock-based compensation from the stated cash flow from operations. Creditors, on the other hand, would welcome share-based compensation because it leaves added cash that could be used to enhance repayment prospects.

Reported under financing activities, The Dress Barn received cash from executives exercising stock options of \$2.65 million. The company also shows the tax savings owing to the deductibility of value of its stock on its tax return. One might question whether the tax savings also should be placed under operating activities owing to their relationship to salaries. You also will see under financing activities the cash from employees to purchase company stock. Again, one might question whether this is really compensation and should be placed as an operating activity, based on its fair value. In my model, I do not make such an adjustment because, unlike an underfunded pension plan, the entity is under no obligation to change its method of compensation. If its stock price fell so low that employees demanded cash in lieu of future stock benefits, the direct impact on cash flow from operations could be substantial. Also, a potential acquirer would need to make a similar analysis to adjust for realistic operating and free cash flow had cash compensation been required.

Getting back to the question of the two companies, one that pays its employees all cash compensation and the other that pays partly in stock, the latter entity would reflect higher operating cash flows. This is why we need to look at cash-flow multiples because that added cost of share-based compensation presumably will convert into additional shares, diluting the existing shareholder population.

Firms normally will attempt to offset the dilution of stock issuance, and in those instances, the economic cost is clear. The Dress Barn, in fact, has been an active acquirer of its shares.

Amounts in Thousands	Fiscal Year Ended		
	July 25, 2009	July 26, 2008	July 28, 2007
Operating activities:			
Net earnings	\$69,688	\$74,088	\$101,182
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	48,535	48,200	45,791
Impairments and asset disposals	8,291	4,110	2,363
Deferred taxes	2,981	9,999	(1,533)
Deferred rent and other occupancy costs	(4,120)	(4,606)	(4,520)
Share-based compensation	6,577	6,612	6,307
Tax benefit on exercise of unqualified stock options	—	—	5,863
Excess tax benefits from stock-based compensation	(863)	(383)	(5,721)
Amortization of debt issuance cost	353	366	372
Amortization of bond premium cost	624	415	108
Change in cash surrender value of life insurance	907	732	(441)
Realized loss on sales of securities	153	304	215
Gift card breakage	(1,788)	(2,184)	(3,724)
Other	18	1,307	(354)
Changes in assets and liabilities:			
Merchandise inventories	(6,574)	10,160	(26,656)
Prepaid expenses and other current assets	1,782	(7,084)	2,171
Other assets	(313)	378	450
Accounts payable	17,856	(12,718)	12,604
Accrued salaries, wages, and related expenses	4,182	(2,128)	4,358
Other accrued expenses	227	(96)	7,313
Customer credits	965	1,865	2,605
Income taxes payable	13,785	1,642	(8,839)
Deferred rent and lease incentives	9,901	13,157	10,028
Deferred compensation and other long-term liabilities	(476)	1,319	5,290
Total adjustments	103,003	71,367	54,050
Net cash provided by operating activities	172,691	145,455	155,232
Financing activities:			
Payment of long-term debt	(1,298)	(1,211)	(1,148)
Purchase of treasury stock	(4,657)	(40,179)	(8,090)
Proceeds from employee stock purchase plan	238	277	299
Excess tax benefits from stock-based compensation	863	383	5,721
Proceeds from stock options exercised	2,657	1,615	6,511
Net cash (used in) provided by financing activities	(2,197)	(39,115)	3,293

Source: The Dress Barn, 2009 10K.

Example:

The cost of stock-based compensation is clearly measurable for Oracle Corporation. Management wrote in its 2009 10K, "We repurchased 225.6 million shares for \$4.0 billion, 97.3 million shares for \$2.0 billion, and 233.5 million shares for \$4.0 billion in fiscal 2009, 2008, and 2007, respectively."

From the cover page of its 10K, Oracle reports the following number of outstanding common shares at the end of their past 4 fiscal years, as well as shares purchased:

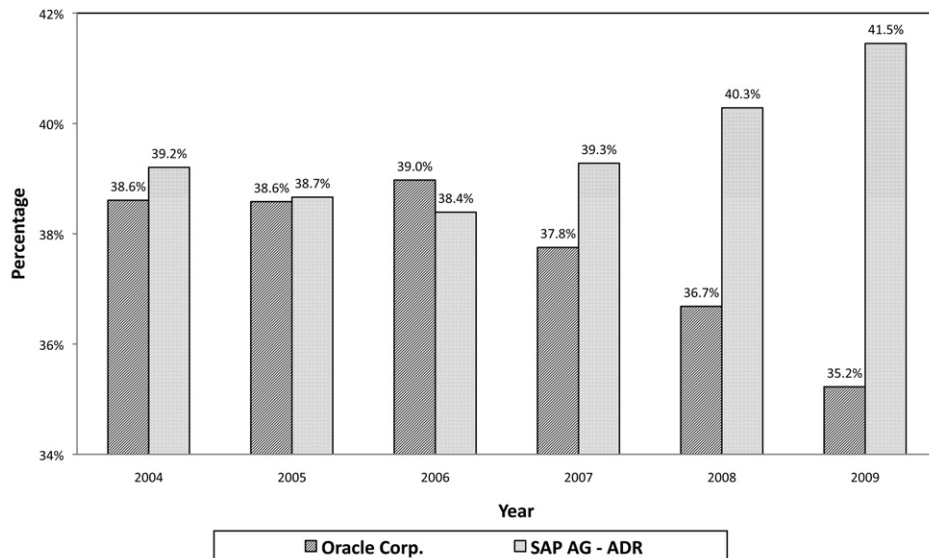
Fiscal Year End	Shares Outstanding	Shares Purchased (million)
May 2009	5,007,230	225.6
May 2008	5,155,842	97.3
May 2007	5,113,035	233.5
May 2006	5,238,329	

While Oracle was active acquiring other entities over the time period shown, the company did so for cash. You can see, then, that Oracle paid \$10 billion to acquire 556.6 million shares, even though its total share count was reduced by just 231,000 shares. It is here that the primary (exclusive of tax) cost of stock-based compensation is seen.

Figure 3-1 shows the marked gap of SG&A/sales for Oracle and SAP, its chief rival, reflecting the bias from the stock-based compensation costs. It is in the SG&A that most of the savings from stock-based compensation would be captured. SAP reports a small fraction of stock-based compensation compared with Oracle. The cost of the large stock-based compensation program is not captured in Oracle's income statement, distorting many of its GAAP-based metrics and allowing it to report higher GAAP-based measures. The true effect is reflected after considering the cost of the acquired shares. Of course, there is no requirement that Oracle do this, but given its history, it should be considered in cash-flow forecasts.

FIGURE 3-1

Oracle Corp. versus SAP Corp. SG&A/Sales, 2004–2009



Example:

Trinity Industries, Inc., is a large manufacturer of heavy metal products such as railcars, marine products, and containers; it also has a leasing subsidiary. In its statement of cash flows, Trinity separates its capital spending from its leasing operation from that of its manufacturing operation. It is imperative that an investor or creditor review and analyze the statement of cash flows for Trinity's leasing operation, which it files (with the Securities and Exchange Commission) separately. For the operating company to receive cash flows from the leasing company, certain excess cash flows and fixed-charge coverage ratios must be met. Otherwise, as we read next, the operating company is required to send cash to the subsidiary, which could well result in a cash strain and an increase in leverage.

The investment activities sections for Trinity and its leasing division are closely intertwined. For example, Trinity (the operating company) historically has entered into agreements (the "Fixed charges coverage agreement") with the leasing subsidiary whereby Trinity is obligated, as stated in the agreement, to make such payments to the subsidiary as may be required to maintain "the Registrant's" (the leasing subsidiary) net earnings available for fixed charges (as defined) at an amount equal to but not less than one and one-half times the fixed charges (as defined) of the subsidiary. These fixed-charge coverage agreements terminate in accordance with their terms at such time as all amounts payable by the subsidiary under the equipment trust certificates⁵ have been paid in full, and the subsidiary shall have delivered a certificate to its CPAs demonstrating that net earnings available for fixed charges, without considering any payments by Trinity, have not been less than one and one-half times the fixed charges in each of the five most recently completed fiscal years, provided that the subsidiary and Trinity agree in connection with "Future financing agreements" to maintain the fixed-charges coverage agreement in force and in effect during the term of such "Future financing agreements."

Certain ratios and cash deposits must be maintained by the leasing group's subsidiaries in order for excess cash flow, as defined in the agreements, from the leasing group to third parties to be available to Trinity.

TRINITY INDUSTRIES, INC., AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (IN MILLIONS)

	Year Ended December 31,		
	2008	2007	2006
Operating activities:			
Net income	\$285.8	\$293.1	\$230.1
Adjustments to reconcile net income to net cash provided by continuing operating activities:			
Loss (gain) from discontinued operations, including gain on sale	1.5	0.7	(14.6)
Depreciation and amortization	140.3	118.9	87.6
Stock-based compensation expense	18.7	18.6	14.0
Excess tax benefits from stock-based compensation	(0.9)	(4.0)	(7.6)
Provision for deferred income taxes	251.3	59.3	75.5

(Continued)

⁵ An equipment trust certificate is used as a financing method by transportation companies. It is basically a bond, the proceeds of which are used to purchase the railcars, with the maturity reflecting the useful life of the asset.

	Year Ended December 31,		
	2008	2007	2006
Gain on disposition of property, plant, equipment, and other assets	(10.5)	(17.0)	(13.5)
Other	(26.5)	(45.7)	(26.6)
Changes in assets and liabilities:			
(Increase) decrease in receivables	43.4	(45.7)	(33.8)
(Increase) decrease in inventories	(25.8)	(50.9)	(124.0)
(Increase) decrease in other assets	(138.0)	(53.2)	(78.7)
Increase (decrease) in accounts payable and accrued liabilities	(128.3)	87.2	5.2
Increase (decrease) in other liabilities	6.9	(16.7)	(0.2)
Net cash provided by operating activities—continuing operations	417.9	344.6	113.4
Net cash (required) provided by operating activities—discontinued operations	1.3	(0.1)	17.4
Net cash provided by operating activities	419.2	344.5	130.8
Investing activities:			
Proceeds from sales of railcars from our leased fleet	222.1	359.3	88.8
Proceeds from disposition of property, plant, equipment, and other assets	20.8	51.0	20.0
Capital expenditures—lease subsidiary	(1,110.8)	(705.4)	(543.6)
Capital expenditures—manufacturing and other	(132.3)	(188.7)	(117.5)
Payment for purchase of acquisitions, net of cash acquired	—	(51.0)	(3.5)
Net cash required by investing activities—continuing operations	(1,000.2)	(534.8)	(555.8)
Net cash provided by investing activities—discontinued operations	—	—	82.9
Net cash required by investing activities	(1,000.2)	(534.8)	(472.9)
Financing activities:			
Issuance of common stock, net	3.1	12.2	18.1
Excess tax benefits from stock-based compensation	0.9	4.0	7.6
Payments to retire debt	(390.8)	(129.5)	(410.2)
Proceeds from issuance of debt	922.5	304.8	920.1
Stock repurchases	(58.3)	(2.9)	—
Dividends paid to common shareholders	(24.2)	(20.2)	(16.3)
Dividends paid to preferred shareholders	—	—	(1.7)
Net cash provided by financing activities	453.2	168.4	517.6
Net (decrease) increase in cash and cash equivalents	(127.8)	(21.9)	175.5
Cash and cash equivalents at beginning of period	289.6	311.5	136.0
Cash and cash equivalents at end of period	\$161.8	\$289.6	\$311.5

Example:

Union Tank Corp. is engaged in the manufacture and leasing of railway tank cars. The company engages in sale-leaseback transactions in which railcars are sold by the company to outside investors and then leased back to customers under operating leases. There are several interesting facets to Union Tank Corp. All the company's stock is owned privately, with Berkshire Hathaway the majority owner. The company files with the Securities and Exchange Commission (SEC) because of debt that is publicly held.

A captive finance operation is meant to facilitate the firm's marketing efforts. It does this by providing the financing by issuing loans or leases to the dealers and customers. From an analytic viewpoint, it is necessary to analyze both entities, the operating and financing companies separately and together, as presented in the consolidated statements. The captive can be structured as a legally separate subsidiary or as a distinct operating division. It can provide the operating, or parent company with a valuable asset that could be monetized or, if liberal in its credit policy along with a weak financial structure, an investment that can bring down the entire organization.

Changes in interest rates also could affect the operating company if they affect product demand or client finances, loans are guaranteed, or variable-rate debt is not hedged. For these reasons, the credit and cash flows of the financial subsidiary must be reviewed separately, including loan covenants and cross-guarantees.

Viewed under financing activities for Union Tank are borrowings from the privately held parent for the construction of railcars. Union Tank is well financed, having \$1.3 billion in equity. The majority of the debt owed to the parent is for the manufacture of railcars, which Union then places under lease. The lessees have easily covered these fixed obligations, even under the strain of the 2007–2009 recession; the company's clients have, according to Union Tank's financial statements, a very low default rate because the company's credit standards are high, selling primarily to investment-grade customers having stable cash flows. Equipment-leasing cash flows are also shown in the table. As with all financial filings, a complete reading of the submission, including the management discussion and analysis, is vital.

As seen for Trinity Industries and other entities with leasing divisions, it is necessary to analyze the leasing component separately from the operating company because the leasing entity exhibits separate and distinct operating and free-cash-flow characteristics. Leasing affiliates are dependent on the financial health of the parent for its success, as is Union Tank on its parent company, the financially strong Berkshire Hathaway. It is also important to understand who its clients are for the products out on lease because, if they were to experience cash-flow strains, the ability of the lessor to service its debt would be compromised. Additionally, the more costly the leased product, such as railcars, the more important it is to understand the financial condition of the lessees. It is essential, when analyzing the operating cash flows of an entity such as Union Tank, to understand the current market values of its products. For instance, in the 2007–2009 period, Union Tank suffered \$60 million in asset write-downs from cars coming off lease. If, on the other hand, Union Tank was in a period of strong demand for its equipment, the company would have the option of reselling the equipment for large gains or putting the equipment back out on lease for higher lease payments.

	2007	2006	2005
Cash flows from financing activities:			
Increase in advances from parent and affiliates	526,924	465,083	—
Proceeds from issuance of debt	—	—	312,121
Principal payments of debt	(216,058)	(85,143)	(40,583)
Cash dividends	(165,000)	(137,000)	(140,000)
Net cash provided by financing activities	145,866	242,940	131,53

(Continued)

The following table presents the scheduled cash inflows and outflows for the railcar and intermodal tank container leasing businesses over the next 5 years based on leases and equipment-related indebtedness outstanding as of December 31, 2007.

	(Dollars in Millions)				
	2008	2009	2010	2011	2012
Equipment leasing cash inflows					
Minimum future lease rentals	\$589.8	\$479.1	\$367.2	\$248.7	\$155.5
Equipment leasing cash outflows					
Minimum future lease payments	40.7	37.6	39.9	42.8	56.0
Principal and interest amount of obligations	173.2	259.9	216.1	108.0	103.5
Excess (deficit) of inflows over outflows	\$375.9	\$181.6	\$111.2	\$97.9	\$(4.0)

Lease Commitments

	Operating Leases		
	Sale-Leaseback	Others	Total
2008	\$38,413	\$7,485	\$45,898
2009	35,412	6,449	41,861
2010	37,758	5,757	43,515
2011	40,753	4,859	45,612
2012	53,956	4,879	58,835
2013 and thereafter	88,231	14,244	102,475
	\$294,523	\$43,673	\$338,196

Source: Union Tank Corp. 2009 10K.

Example:

Beacon Enterprise Solutions Group, Inc. (and subsidiaries) is a provider of global, international, and regional telecommunications and technology systems. Its 2009 10K illustrates a number of transactions, culminating in the company's \$4.3 million preferred offering. As shown by the difference between proceeds and repayment amounts, the company's investment bankers and investors in the prefinancings did well. Beacon sold several issues via a private placement with yields of 12 percent plus issuance of warrants. During the year, the company borrowed \$400,000 and repaid \$450,000 on its line of credit. The cost of capital is onerous for entities with a history of operating losses and deficit net worth, such as Beacon, which paid very large fees to investors to lure investor interest.

	2009	2008
Cash flows from financing activities:		
Proceeds from issuances of convertible notes		500,000
Proceeds from issuances of bridge notes and other short-term notes	422,000	700,000
Proceeds from sale of preferred stock, net of offering costs	4,276,460	—
Proceeds from sale of common stock, net of offering costs	1,035,216	4,346,672
Proceeds from lines of credit	400,000	343,000
Proceeds from note payable	600,000	—
Payment of note offering costs		(75,000)
Repayment of line of credit	(450,000)	(393,000)
Repayment of convertible notes		(202,001)
Payments of notes payable	(985,514)	(534,389)
Payments of capital lease obligations	(13,562)	(11,928)
Net cash provided by financing activities	5,284,600	4,673,354

Example:

Tucson Electric is an electric utility company owned by Unisource, Inc. The following example, from its 2009 10K, illustrates the reporting of capital lease obligations in the statement of cash flows. GAAP requires recording the reduction in the lease obligation as a financing activity, whereas the interest portion must be reported as an operating activity. For operating lease obligations, the payment is recorded in its entirety as an operating activity. Therefore, capital leases for the identical asset and under similar monthly payment (term of lease may differ) will allow the entity to report higher operating cash flows.

When a lessor enters into an operating lease, payments received are recorded as operating activities, and if it enters into a capital lease, it classifies any cash paid to purchase that asset that is subsequently leased out as an investment activity.

	2009	2008	2007
Cash flows from financing activities:			
Proceeds from issuance of long-term debt	—	220,745	—
Proceeds from borrowings under revolving credit facility	171,000	170,000	160,000
Repayments of borrowings under revolving credit facility	(146,000)	(170,000)	(180,000)
Payments of capital lease obligations	(24,091)	(74,228)	(71,464)
Repayments of long-term debt	—	(10,000)	—
Dividends paid to UniSource Energy	(60,000)	(2,500)	(53,000)
Equity investment from UniSource Energy	30,000	—	18,000
Other cash receipts	2,447	1,237	7,795
Payment of debt issue/retirement costs	(1,329)	(3,120)	(451)
Other cash payments	(1,347)	(3,421)	(968)
Net cash flows—financing activities	(29,320)	128,713	(120,088)

CASH FLOWS FROM OPERATING ACTIVITIES

The FASB defined cash flows from operating activities as “all transactions and other events that are not defined as investing or financing activities.” It broadly explained that “operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effect of transactions and other events that enter into the determination of net income” (SFAS 95, para. 21). The FASB provided a list of specific cash flows from operations:

- a. Cash receipts from sales of goods or services, including receipts from collection or sale of accounts and both short- and long-term notes receivable from customers arising from those sales.
- b. Cash receipts from returns on loans, other debt instruments of other entities, and equity securities—interest and dividends.
- c. All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits; proceeds of insurance settlements except for those that are directly related to investing or financing activities such as from destruction of a building; and refunds from suppliers [SFAS 95, para 22].

It further described cash outflows for operating activities as

- a. Cash payments to acquire materials for manufacture or goods for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods.
- b. Cash payments to other suppliers and employees for other goods or services.
- c. Cash payments to governments for taxes, duties, fines, and other fees or penalties.
- d. Cash payments to lenders and other creditors for interest.
- e. All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers [SFAS 95, para 23].⁶

⁶ There are other cash outflows that should be noted here. For example, there is a 20 percent excise tax when severance pay totals more than three times an executive’s average income—including all forms of compensation—over the prior five years. Since outstanding options normally vest upon severance, the tax almost always kicks in. Also, so called “gross-ups,” whereby the firm pays the executives income taxes, whether due to severance, a bonus, or a merger, can be very costly.

Clearly, the FASB treated cash flows from operations as the “residual” cash flow; it consists of all events that are not classified as either investing or financing activities. For many firms, the net cash flow from operating activities is likely to contain special items that are not easily assignable to investing or financing cash flows and that may not recur in the future, such as the settlement of a law suit. Thus the analyst ideally should separate the nonrecurring and special items from other operating cash flows. However, this is not easily done in practice because most firms follow the indirect approach to disclosing the cash flows from operating activities.

As noted, repayments under capital leases are treated as a financing activity, and the payment for interest under the same lease is estimated and is included as an operating activity. It would be more appropriate if the entire payment were placed under financing activities.

Assets that are sold at a gain can distort operating cash flows because the tax implications are listed as an operating activity, whereas the gain related to the sale is placed as an investing activity. A more proper placement would be to place both, as separate items, under investing activities.

In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method). Enterprises that do so should, at minimum, report the following classes of operating cash receipts and payments separately:

1. Cash collected from customers, including lessees, licensees, and the like
2. Interest and dividends received
3. Other operating cash receipts, if any
4. Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like
5. Interest paid
6. Income taxes paid
7. Other operating cash payments, if any

Additionally, for some items, such as postretirement benefits and asset retirement obligations, we include the (net) cost for the period rather than actual cash outflows in order to separate what we view as financing of these obligations from the operating-cost component. If the company is funding postretirement obligations at a level substantially below its net expense (service cost and net interest cost), this is equivalent to borrowing, which bolsters reported cash flow from operating activities.

Enterprises are encouraged to provide further breakdowns of operating cash receipts and payments that they consider meaningful and feasible. For example,

a retailer or manufacturer might decide to further divide cash paid to employees and suppliers (category 4 above) into payments for costs of inventory and payments for selling, general, and administrative expenses (SFAS 95, para. 27).

Net cash flow from operating activities indicates the amount of cash that the firm was able to generate from (or needed to spend on) its ongoing business activities. Ideally, a firm should be able to generate cash from its business activities in every period because operating cash flows are prior to debt repayment and capital spending. However, in reality, many financially healthy firms generate cash from their business activities in most periods but spend more cash on their business activities than they receive from customers in some periods. Also, a firm may be in the development stage of its business. It may invest in developing its products or in setting up production facilities and distribution channels (investment activities), whereas larger cash receipts from customers are expected to occur only in the future. Another example is a seasonal business that invests in setting up inventories during one or two quarters, whereas most sales are made during other quarters (such as during the holiday season). Operating cash flows are likely to be negative during the quarters when inventories are built but positive in quarters when inventories are sold.

For some periods, and for some firms, a negative net cash flow from operations is acceptable, such as a manufacturer that works on long-term contracts (a shipbuilder) and must retool and build inventories during the initial stages of production. However, in the majority of cases, a positive net cash flow from business activities is expected. A business that spends more cash on its ongoing activities than it generates has to finance these activities somehow. It can just use up its cash reserves, it can borrow additional cash, it can raise additional equity, or it can liquidate investments or fixed assets. But none of these options can be sustained for prolonged periods. For example, it is unlikely that creditors will keep lending to a business that continuously does not generate an acceptable level of cash from its operations, resulting in a low ROIC. Similarly, liquidation of necessary assets may reduce the chances of generating cash flows from operations in the future. Thus continuous negative cash flows from operating activities (which are unrelated to a seasonal business or the operating cycle of the business) should be examined carefully by the cash-flow analyst.

In addition to net cash flows from operating activities, one should examine the components of cash flows. Actual cash inflows begin with the collection of cash from accounts receivable. The ease with which the entity collects its accounts receivable is an important determinant of its financial flexibility. Improvements in the collection period begin at the credit approval. For small, unknown, or startup entities, a greater degree of due diligence by the credit analyst is needed to enhance operating cash flows. We shortly discuss the credit process.

Reductions in accounts receivable, next to planned reductions in inventory, are the most sought-after ways to manage operating cash flow. Faster collection periods, made possible by improved credit-analysis software that enables the firm's credit analyst to review prospective and existing accounts, has improved the operating-cash-flow cycle. Additionally, the conservative use of customer credits and discounts has helped to improve the flow of collections.

TABLE 3-1

Largest Producers of Operating Cash Flow, 2008 (\$000)

Company Name	Operating Cash Flow (\$000)
AT&T, Inc.	33,656
BHP Billiton Group (AUS), ADR	18,159
BHP Billiton Group (GBR), ADR	18,159
BP PLC, ADR	38,095
Canadian Natural Resources	8,283
Chesapeake Energy Corp.	5,236
Chevron Corp.	29,632
China Mobile, Ltd., ADR	28,384
China Petroleum & Chem., ADR	9,925
China Telecom. Corp., Ltd., ADR	11,250
China Unicom (Hong Kong), ADR	8,403
ConocoPhillips	22,658
Daimler AG	4,461
Deutsche Telekom AG, ADR	21,391
Devon Energy Corp.	9,408
E.ON AG, ADR	9,400
Encana Corp.	8,855
ENEL Spa, ADR	14,629
ENI SPA -ADR	30,343
Exxon Mobil Corp.	59,725
Ford Motor Credit Co., LLC	9,128
France Telecom, ADR	20,877
Gazprom O A O, ADR	24,419
General Electric Cap. Corp.	31,262
General Electric Co.	48,601
GMAC, LLC	14,095
Hertz Global Holdings, Inc.	2,096
Honda Motor Co., Ltd., ADR	3,869
Lukoil Oil Co, ADR	14,312
Marathon Oil Corp.	6,782

(Continued)

TABLE 3-1 (Continued)

Largest Producers of Operating Cash Flow, 2008 (\$000)

Company Name	Operating Cash Flow (\$000)
Nippon Telegraph & Telephone, ADR	25,357
Nissan Motor Co., Ltd., ADR	13,443
ORIX Corp., ADR	3,143
Petrobras Brasileiro, ADR	28,220
Petrochina Co., Ltd., ADR	24,992
Repsol YPF SA, ADR	8,341
Rio Tinto Group (AUS), ADR	14,883
Rio Tinto Group (GBR), ADR	14,883
Royal Dutch Shell, PLC, ADR	43,918
Statoilhydro ASA, ADR	14,699
Telefonica SA, ADR	22,780
Total SA, ADR	25,985
Toyota Motor Corp., ADR	15,035
Vale SA, ADR	14,137
Verizon Communications, Inc.	26,620
Vodafone Group, PLC, ADR	17,465
Volkswagen AG, ADR	22,925
Wal-Mart Stores, Inc.	23,147
XTO Energy, Inc.	5,235

DIRECT METHOD

The FASB has provided firms with the option of reporting cash flows from operations using the direct or the indirect method, although the accounting rule maker has clearly advocated a preference for the clarity of the direct method. A joint task force between FASB and the International Accounting Standards Board (IASB) also has advocated a preference for the direct method and has urged companies to switch to the direct method. The cost of preparing under the direct method has resulted in very few companies preparing under the preferred method. Also, perhaps, some entities do not want to reveal the information the direct method provides, although the analyst can estimate such a report, as we will see.

Under the direct method, the main categories of operating cash flows reported in the statement are very similar to how the small local business would evaluate them: cash collections from customers minus payments to suppliers. The basis for the direct method is the simple identity

$$\text{Net income} = \text{revenues} - \text{expenses}$$

We can examine individual revenues and expenses and exclude those which are noncash revenues or expenses, as well as those which are not due to operating events. For example, a firm may record income from unconsolidated subsidiaries that is carried on the balance sheet using the equity method. This income is included in net income but is a noncash event if cash dividends are not paid by the subsidiary. Similarly, suppose that the firm sold some old property, plant, and equipment (PPE) at a gain. This gain is included in net income but reflects an investing cash flow and not an operating cash flow. You also will see how entities book hedging gains into net income, which are reversed in the operating cash flow section because those too are noncash events.

Examples of noncash expenses include depreciation and deferred taxes. Thus we can rewrite the accounting identity as

$$\text{Net income} = \text{CR} + \text{NCR} - (\text{CE} + \text{NCE})$$

where

CR=cash revenues from operating activities

NCR=noncash revenues or nonoperating cash flows

CE=cash expenses from operating activities

NCE=noncash expenses or nonoperating expenses (which are included among expenses)

Simple algebra yields

$$\text{CR} - \text{CE} = \text{net income} + \text{NCE} - \text{NCR}$$

By definition, $\text{CR} - \text{CE}$ is identical to the cash from operating activities. It can be derived by adjusting net income for revenues and expense events that are either non-cash or nonoperating cash flows. In particular, we *add* noncash (or nonoperating) expenses because they were subtracted from income to derive net income and *subtract* noncash (or nonoperating) revenues because they were added to income in deriving net income.

The FASB's encouragement to use the direct approach in reporting operating cash flows has not met with success. This is unfortunate because a more logical starting point is that of cash collections from customers rather than a reconciliation beginning with net income. Perhaps the reluctance is because the FASB requires firms that use the direct method to add a schedule that reconciles net income with operating cash flow. Thus, when a firm adopts the direct method for reporting operating cash flows from operating activities, it has to supply *all*

the information that is required from a firm that uses the indirect method, but in addition, it has to supply information about the major components of operating cash flows. Obviously, reasonable managers will opt to minimize their exposure to costly additional disclosure and mostly will use the indirect method for reporting.

An analyst can create a direct-method worksheet by using the balance-sheet changes and the income statement, if so desired. Creating a worksheet using the direct method may not be precisely comparable with that of a company reporting under the indirect format for several reasons. For example, the change in accounts receivable may not match the statement of cash flows where the indirect method is used if some of the company's receivables are caused by the sale of fixed assets; these receivables should not be considered as a change in operating cash flows because these receivables are related to disinvesting cash flows. Accordingly, a discrepancy in other balance-sheet items may not be due to operating activities but rather to investing or financial activities. It is prudent for the analyst, nonetheless, to review changes in the balance-sheet items to see how those differences compare with the changes as listed in the statement of cash flows under the indirect method.

Next, I show a template for estimating cash flow from operations for a company that reports under the direct method, Nu Horizons Electronics.⁷ One might ask why it is necessary to construct a direct-method approach if basic cash-flow information is already given under the indirect method. To begin, it is important to know how to do this because often, when an entity releases preliminary financial results, it does not provide a statement of cash flows (merely an income statement and balance sheet), so even if one is constructed based on a lack of complete data, it will provide very useful information other investors do not have; it will show how the company is collecting cash, where it is coming from, its magnitude, and where it is being spent. The analyst will be able to compute the approximate cash burn or free cash flow that took place during the reporting period. Also, during interim periods, the entity often reports a limited statement of cash flows. We see this for Berkshire Hathaway, which reported cash flow from operating activities as a single-line entry. Additionally, a direct-method approach is a more natural method—cash in and cash out. For instance, isn't a line entry for taxes paid as part of operating activities more reflective of cash flows than deferred taxes? Compare the two formats using Nu Horizons with others in this book.

⁷The 2009 10K for Nu Horizons Electronics Corp. may be found on Edgar at www.sec.gov/Archives/edgar/data/718074/000114420409022970/v147330_10-k.htm.

NU HORIZONS ELECTRONICS CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Years Ended		
	February 28, 2009	February 29, 2008	February 28, 2007
			(As restated)
Increase (decrease) in cash and cash equivalents:			
Cash flows from operating activities:			
Cash received from customers	\$789,991,000	\$716,847,000	\$722,922,000
Cash paid to suppliers and employees	(728,820,000)	(732,359,000)	(700,393,000)
Interest paid	(3,035,000)	(4,500,000)	(4,129,000)
Interest received	100,000	241,000	580,000
Income taxes paid	(2,148,000)	(11,191,000)	(2,701,000)
Net cash provided by (used in) operating activities	56,088,000	(30,962,000)	16,279,000
Cash flows from investing activities:			
Capital expenditures	(2,186,000)	(2,808,000)	(1,069,000)
Acquisition payment DT Electronics	(3,410,000)	(1,744,000)	(6,098,000)
Acquisition of Dacom-Süd Electronic Vertriebs GmbH	—	(2,593,000)	—
Acquisition payment C-88	(4,042,000)	—	—
Net cash (used in) investing activities	(9,638,000)	(7,145,000)	(7,167,000)
Cash flows from financing activities:			
Borrowings under revolving credit line	298,720,000	317,605,000	214,933,000
Repayments under revolving credit line	(345,223,000)	(280,029,000)	(236,305,000)
Proceeds from exercise of stock options	355,000	210,000	2,726,000
Realized tax benefit of compensation expense	(5,000)	—	1,413,000
Proceeds from settlement of subordinated note	—	—	2,000,000
Net cash (used in) provided by financing activities	(46,153,000)	37,786,000	(15,233,000)
Effect of exchange-rate changes	610,000	(540,000)	(5,000)
Net increase (decrease) in cash and cash equivalents	907,000	(861,000)	(6,126,000)
Cash and cash equivalents, beginning of year	3,886,000	4,747,000	10,873,000
Cash and cash equivalents, end of year	\$4,793,000	\$3,886,000	\$4,747,000

NU HORIZONS ELECTRONICS CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	For the Years Ended		
	February 28, 2009	February 29, 2008	February 28, 2007
			(As restated)
Net sales:	\$750,954,000	\$747,170,000	\$668,591,000
Costs and expenses:			
Cost of sales	637,261,000	626,771,000	554,266,000
Selling, general and administrative expenses	113,010,000	112,473,000	94,891,000
Goodwill impairment charge	7,443,000	—	—
	757,714,000	739,244,000	649,157,000
Operating income (loss):	(6,760,000)	7,926,000	19,434,000
Other (income) expense:			
Interest expense	3,141,000	4,570,000	3,850,000
Interest income	(100,000)	(241,000)	(580,000)
	3,041,000	4,329,000	3,270,000
Income (loss) before provision (benefit) for income taxes and minority interests:	(9,801,000)	3,597,000	16,164,000
Provision (benefit) for income taxes	(837,000)	766,000	7,991,000
Income (loss) before minority interests:	(8,964,000)	2,831,000	8,173,000
Minority interest in earnings of subsidiaries	271,000	312,000	456,000
Net (loss) income:	\$(9,235,000)	\$2,519,000	\$7,717,000
Net (loss) income per common share:			
Basic	\$(0.51)	\$0.14	\$0.43
Diluted	\$(0.51)	\$0.14	\$0.41
Weighted average common shares outstanding:			
Basic	18,043,834	17,931,356	17,871,671
Diluted	18,043,834	18,582,130	18,641,475

NU HORIZONS ELECTRONICS CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	For the Years Ended	
	February 28, 2009	February 29, 2008
		(As restated)
Assets:		
Current assets		
Cash	\$4,793,000	\$3,886,000
Accounts receivable—less allowances of \$3,438,000 and \$4,269,000, respectively	111,572,000	150,270,000
Inventories	107,877,000	134,691,000
Deferred tax asset	3,323,000	3,135,000
Prepaid expenses and other current assets	4,979,000	4,306,000
Total current assets	232,544,000	296,288,000
Property, plant, and equipment, net	4,827,000	4,529,000
Other assets		
Cost in excess of net assets acquired	5,020,000	9,925,000
Intangibles, net	3,742,000	2,500,000
Other assets	5,222,000	5,101,000
Total assets:	\$251,355,000	\$318,343,000
Liabilities and shareholders' equity:		
Current liabilities		
Accounts payable	\$67,133,000	\$79,236,000
Accrued expenses	8,202,000	8,615,000
Due to seller	296,000	3,245,000
Bank debt	8,450,000	603,000
Income taxes payable	1,322,000	133,000
Total current liabilities:	85,403,000	91,832,000
Long-term liabilities		
Bank debt	14,950,000	69,300,000
Due to seller	190,000	—
Executive retirement plan	2,400,000	1,684,000
Deferred tax liability	1,903,000	2,072,000
Total long-term liabilities:	19,443,000	73,056,000
Minority interest in subsidiaries	2,532,000	2,261,000

(Continued)

NU HORIZONS ELECTRONICS CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS *(Continued)*

	For the Years Ended	
	February 28, 2009	February 29, 2008
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$1 par value, 1 million shares authorized; none issued or outstanding	—	—
Common stock, \$0.0066 par value, 50 million shares authorized; 18,578,946 and 18,392,457 shares issued and outstanding as of February 28, 2009 and February 29, 2008, respectively	122,000	121,000
Additional paid-in capital	56,386,000	54,979,000
Retained earnings	87,386,000	96,621,000
Other accumulated comprehensive income (loss)	83,000	(527,000)
Total shareholders' equity:	143,977,000	151,194,000
Total liabilities and shareholders' equity:	\$251,355,000	\$318,343,000

How to Estimate Cash Flow from Operations

1. To estimate cash collections from customers, we use the following template:

	Item	Source
Cash collections from customers:		
+ Net sales	\$750,954,000	Income statement
± Decrease in accounts receivable	\$38,698,000	Balance sheet
± Increase in deferred revenue		Balance sheet or footnote
Total	\$789,652,000	

Entities account for revenue recognition under various FASB and SEC guidelines. In the case of Nu Horizons, the company records revenues at the time its products are shipped. Some firms, as seen in the template, receive cash from customers as prepayments for future products or services, known as

deferred revenue. This would be the case for prepayment of a magazine or software subscription.

Nu Horizon does not show a line entry for deferred revenue, so the line is left blank in the template. If the change in deferred revenues had increased, we would have added it to cash collections. The \$38,698,000 is derived from the changes in the yearly balance sheets. Often, as stated, an entity will include in its receivables cash not due to trade but rather, for instance, due to the sale of an asset. We would exclude this from our estimate of cash flow from operations because such a transaction would be due to disinvesting cash flows. We see on the balance sheet that there was a small change in the bad debt allowance for receivables. If it were large (2 percent or more of sales), we would attempt to determine the amount of the charge-off and the reasons behind it. As seen, the template is very close to the \$790 million reported under the direct method.

2. To estimate cash payments to suppliers, we use the following template, which should be used in conjunction with cash collections from customers (shown above). Cash payments to suppliers is equal to the cost of purchases (cost of goods sold plus the increase in inventory) and the payments to suppliers (cost of purchases plus the decrease in accounts payable).

Nu Horizons reports a single-line entry for cash paid to suppliers *and* employees, whereas other firms using the direct method show a separate line entry as cash paid to suppliers. To estimate this single entry for Nu Horizons, we would need to complete steps 2 and 3 of this template. This estimated as \$723 million, or slightly below that actually reported. The estimation computation is shown. It represents the net cash outlay of goods used to sell to customers.

Item	Source
Cash payments to suppliers:	
+ Cost of goods sold	Income statement
± Inventory increase/decrease	Balance sheet
± Accounts payable decrease/increase	Balance sheet
Total	

To accurately reconcile cash paid to suppliers and employees as appeared in the statement of cash flows, I enlisted the aid of Nu Horizons' CFO. However, the estimation method most often—but not always—results in a fairly close approximation that is necessary for the evaluating cash flow from operations. Feel free to copy the worksheets and complete them for Nu Horizons also using the actual reconciliation as a guide.

Cost of sales	(637,261,000)
Operating expenses	(120,453,000)
Adjustments:	
Depreciation and amortization	2,239,000
Bad debt provision	(341,000)
Goodwill write-off	7,443,000
Deferred taxes	(431,000)
Loss on sale of fixed asset	27,000
Income tax benefit from stock options exercised	5,000
Stock-based compensation	1,127,000
Retirement plan	716,000
Changes in assets and liabilities—increase/(decrease):	
Inventory	26,813,000
Prepaid expenses/other current assets	(673,000)
Accounts payable and accrued expenses	(8,675,000)
Income taxes payable	(2,148,000)
Retirement plan	0
Other adjustments (taxes paid, reversals, interest accrual)	2,878,000
(Rounding adjustment)	2,000
Cash paid to suppliers:	(728,820,000)

3. Cash paid for other operating expenses may be estimated using the following template:

Item	Source
Cash paid for other operating expenses:	
+ Sales and marketing	Income statement
+ Other general and administrative	Income statement
– Depreciation and amortization	Income statement
± Other working capital	Balance sheet
Total	

4. If available, the analyst should use the actual cash taxes taken directly from the statement of cash flows or footnote. Alternatively, the analyst can use the following template to estimate taxes:

Item	Source
Cash paid for other operating expenses:	
± Provision for income taxes	Income statement
± Increase in deferred taxes	Balance sheet
± Increase in accrued income taxes	Balance sheet
Total	

Here is one of the big advantages of SFAS 95: the reporting of the actual tax payment, which at \$2.148 million is a bit greater than the \$1.015 million that would have been estimated prior to the pronouncement, given the \$837,000 provision and \$188,000 increase in the deferred tax asset. For Nu Horizons, the \$2.148 million is deducted because it is included as part of other adjustments (\$2,878) as taxes paid, and the company needs to show it as a separate line item.

5. Other cash flows. For Nu Horizons, this would consist of cash interest paid and received.

Item	Source
Other cash flows:	
+ Other income	Income statement
Total	

The analyst constructing his or her own statement of cash flows might find a large variation between reported and estimated taxes. Normally, differences occur when not all tax-related balance-sheet accounts are disclosed separately. For example, some prepaid or deferred taxes that represent an asset may be included with prepaid and other assets on the balance sheet. Some deferred tax liabilities may be included with other liabilities. In these cases, it is difficult to estimate the cash taxes paid during a period in a reasonable manner. Again, the actual cash paid for taxes is disclosed separately in the statement of cash flows (or in a footnote) for firms that use the indirect method to derive cash-flow operating activities. Also, during interim periods, the effective tax rate is an estimate of the year-end rate.

Finally, regarding the estimation template, very little information might be available to approximate the “other operating cash flows.” Often it will be a “plug” figure and is likely to contain an estimation error. If it is of consequence, the analyst would need to speak to a financial officer at the company to determine the source(s) of any discrepancy, and in any event, if the number is significant, one would want to understand how the company is being managed. Normally, the estimation error is small because the taxes paid can be reasonably estimated, and other sources of income and expense are reported.

CREDIT, COLLECTIONS, AND TREASURY DEPARTMENT SOFTWARE

A discussion of cash flow from operations would be incomplete without reviewing credit and collection. Good credit decisions enhance cash flows, permitting the addition of value-adding opportunities. Related are asset sales and a rebalancing of the corporate portfolio that are designed to aid operating cash flows.

With advances in software, credit department analysts today have at their fingertips real-time information needed to make quick, informed decisions. This information includes cash held in banks worldwide, investment schedules, invoices, inventory, payables, customer credit limits, delivery schedules, and an aging schedule of the entity's accounts receivable. Credit managers claim that accounts receivable software, including electronic invoicing, has helped them to reduce their days of sales outstanding by as much as 20 days and has reduced the number of disputed bills and dealings with sales representatives. The software quickly shows if a client is late on payment, with a decision if shipping additional product is warranted. The credit department also may be responsible for monitoring current and forward credit exposure related to financial instruments, as well as providing for letters of credit or other necessary such financings to aid sales and the firms' clients.

While "involuntary" increases in receivables and inventories do occur, advances in computer software monitor all phases of the firms' production to minimize and capture their occurrence so that they are less frequent than they once were. When large bad credits do arise, their effects are felt throughout the enterprise, with possible ramifications on planned outlays. Such software improvements are part of the explanation for the longevity of business expansions after the 1980s. Even the recession that started during 2007 did not find most businesses with severe excess inventory.

The collection process is where the cash inflows begin, and collections is the department within treasury that receives much attention. Although some credit analysts measure the success of such departments by the average collection period,⁸ such a metric does not provide them with the more important timely collection and credit information, such as (1) which clients pay their bills on time and might be accorded credit, and (2) which clients have run into such severe payment problems that further delivery of goods is unjustified—and whose accounts probably should be classified as a bad debt.

Computer software has made this function of the credit manager much easier. With the push of a button, most credit managers can check the payment history of their clients over many years, thereby making the credit-approval process quicker, simpler, and more accurate. Software prioritizes daily collection calls and facilitates collaboration between departments. Credit managers still use time-honored techniques to reduce their bad debt expense and aid the accounts receivable process (i.e., minimize the nominal amount of receivables outstanding). Credit service agency reports, such as Dun & Bradstreet (D&B) credit reports, are still used widely, although many credit managers feel that the data in such reports are to a

⁸ The average collection period is defined as $360/\text{average accounts receivable turnover}$. In turn, the accounts receivable turnover is defined as $\text{net sales}/\text{average accounts receivable}$.

great extent outdated. D&B reports can be helpful if they show lawsuits against the company, show the company's financial statement, or show the employment and educational backgrounds of key employees.

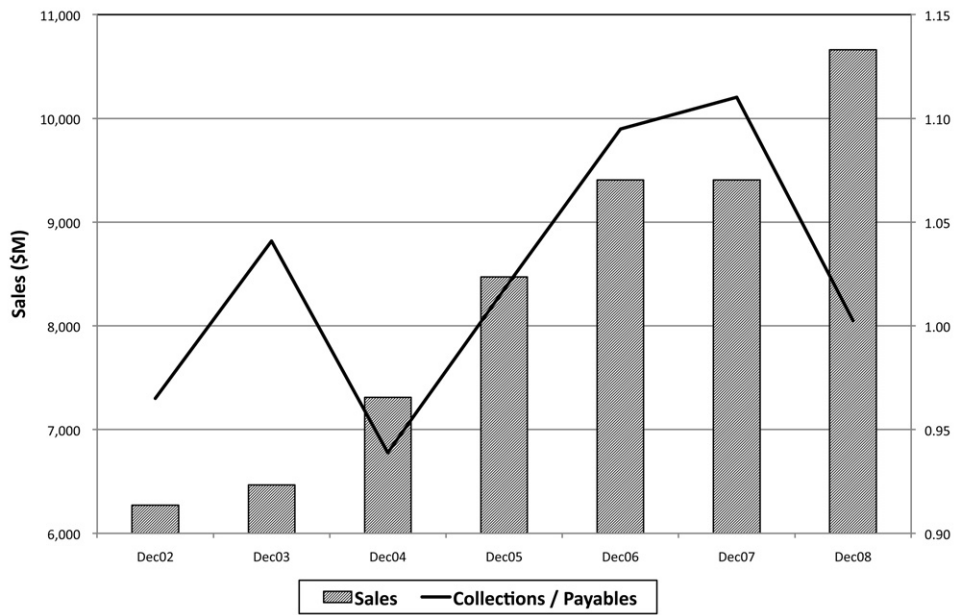
Trade references, which also help the credit analyst gather information about potential clients, come in a variety of sources. The new-account customer application designates areas for both trade and bank referrals. Sales professionals, who visit the prospective new account's offices and facilities, are likely to spot the products of companies that can be called for references, even though those firms might not be listed on the credit application. The credit application itself usually provides useful information to the credit analyst.

Good credit analysis is vitally important in helping an enterprise's cash flow because errors by credit department analysts can be very costly. Trade shows (friends in the industry) and reference checks of the client's competitors are also very useful. So are telephone leads resulting from the questioning of competitors. Analyzing financial statements for trends in operating free cash flow, free cash flow, and leverage are essential to the credit analyst because cash-flow trend is a leading indicator of financial failure. Newspapers, magazines, and the Internet are also likely to bring a flow of financial information into the credit department, especially for larger customers. Some credit managers take a very careful approach to rumored takeover candidates because direct credit downgrades often result after a takeover.

A pattern of declining receipts from customers may indicate a maturing product, softening of demand, a more stringent credit policy toward customers, or some other problem, such as the loss of a key employee. The cash-flow analyst would be interested in ascertaining the reasons for any such development and may do so by examining and speaking with other firms in the industry along with client discussions of client contact.

A simple ratio that can illustrate the credit-granting policy of the firm or its ability to collect its accounts receivable is the ratio of collections to sales. Collections from customers can be estimated as sales minus the change in accounts receivable, similar to computation of the direct method of cash flow from operations. One then can divide collections during a period by sales in the same period. When operations are relatively stable, this ratio is likely to hover around 1; that is, most sales are collected within the year. However, if the ratio reveals a declining trend, the quality of a firm's receivables should be questioned by the cash-flow analyst. For firms using the direct method, cash collections is already given.

Similarly, if one observes a significant increase in cash payments to employees and suppliers that is beyond the proportionate increase in cash receipts from customers, the cash-flow analyst should examine whether the firm is experiencing an alteration in demand for its products or perhaps a prior "push" on collections that is currently being reversed or normalized. For example, the firm may have problems marketing its products and therefore is caught with unwanted buildup of

FIGURE 3-2**Norfolk Southern Corp.: Sales and Collections**

inventories, inability to compete, or a downswing in the economy. It may spend more cash on selling, general, and administrative expenses than is warranted by the level of customer demand. Sometimes a firm may incur greater administrative costs in one period because it may make substantial changes in its operations (such as computerizing its operations). However, one should not observe continuous increases in cash payments to suppliers and employees beyond those called for by increases in demand for the company's products and services.

In Figure 3-2, notice that sales for Norfolk Southern, a large transportation firm, showed a consistent increase during the 6 years ending December 2008. The ratio of collections to payables is very stable at around 1. This is to be expected given the relatively stable business of railroads, as well as the consistent payment record of its clients.

ASSET SALES

For entities needing to raise cash, asset sales are always considered in addition to external financing. The least costly capital raise always will be considered first, especially if the financial turbulence is expected to be short term and the cost of debt and equity is high.

The continual sale of inventory for below-market prices or accounts receivable factoring normally provides an unmistakable warning that should raise a flag for students of cash flow and risk because the realization price reflects a cost that would not normally be acceptable to a well-financed organization. Asset sales are often a de facto partial liquidation. Continuing asset sales that take place for lower-than-balance-sheet values are indeed telltale signs.

To improve operating cash flows, companies often sell operating divisions as they rebalance their portfolio of companies in search of the highest return opportunities. Small asset sales and balance-sheet management typically constitute good business practice and add to free cash flow and reduced cost of capital. Managers committed to weeding out poorly performing business units can enhance their company's market valuation significantly.

Significance, in accounting parlance, relates to size and whether the failure to report an event as a separate line item would mask a change in earnings or trend. The analyst should determine if the company under analysis has indeed sold assets during any particular reporting period owing to weakness in its borrowing capacity or an attempt to bolster disappointing operation cash flow. Both Enron and Delphi Corp., prior to their bankruptcies, were selling inventory with the understanding that it would be repurchased at a later period, a clever way to raise cash but a telling sign of liquidity shortfall.

The securitization of assets for sale into a special-purpose entity, as was invoked by Enron, may not, by itself, represent a reason to sell a security or dismiss the purchase of one, especially in light of otherwise undervaluation by the marketplace. In fact, many companies have raised cash via the securitization of accounts receivable, redeploying those funds back into a business that resulted in high rates of growth in cash flows. When viewed under the light of other metrics, asset sales could form part of a mosaic indicative of a financial risk urging avoidance of the particular security or to place a higher discount rate on its free cash flow, accounting for the new, higher level of uncertainty.

Entities that have substantial accounts receivables, such as retailers, often discount these future cash receipts for immediate cash, as Macy's did during 2006. Figure 3-3 reveals the impact on its average collection period resulting from that sale. Of course, average collection period and similar credit metrics, such as cash conversion cycle, will be distorted by the sale of receivables.

Selling receivables boosts current-period operating cash flow and thus must be normalized by the analyst in evaluating historical and prospective cash flows. To do so, one would compute the past 4 years' average accounts receivable to sales and apply that to the current year as if the financing did not occur. At this point, the analyst can evaluate the operating and power cash flows for that year, including the sales of receivables.

More important, since the upcoming year's cash collections will be lower, an updated cash-flow projection must reflect the new expected collections, with

emphasis on the ability of the entity to retire or recast upcoming debt and other obligations coming due. Macy's has, according to its "Financing" footnote, \$2.6 billion in principal payments due over the coming 3 years. Since prospective cash flows will be diminished by the present value of the change in future collections, fair value could shift, depending on how the cash from the sale is deployed. In its statement of cash flows, the drop in cash flows from operations is apparent, with management reacting by cutting budgets company-wide.

MACY'S, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Millions)

	2008	2007	2006
Cash flows from continuing operating activities:			
Net income (loss)	\$(4,803)	\$893	\$995
Adjustments to reconcile net income (loss) to net cash provided by continuing operating activities:			
(Income) loss from discontinued operations	—	16	(7)
Gains on the sale of accounts receivable	—	—	(191)
Stock-based compensation expense	43	60	91
Division consolidation costs and store closing-related costs	187	—	—
Asset impairment charges	211	—	—
Goodwill impairment charges	5,382	—	—
May integration costs	—	219	628
Depreciation and amortization	1,278	1,304	1,265
Amortization of financing costs and premium on acquired debt	(27)	(31)	(49)
Gain on early debt extinguishment	—	—	(54)
Changes in assets and liabilities:			
Proceeds from sale of proprietary accounts receivable	—	—	1,860
Decrease in receivables	12	28	207
(Increase) decrease in merchandise inventories	291	256	(51)
(Increase) decrease in supplies and prepaid expenses	(7)	33	(41)
Decrease in other assets not separately identified	1	3	25
Decrease in merchandise accounts payable	(90)	(132)	(462)
Decrease in accounts payable and accrued liabilities not separately identified	(227)	(396)	(410)
Increase (decrease) in current income taxes	(146)	14	(139)
Decrease in deferred income taxes	(291)	(2)	(18)
Increase (decrease) in other liabilities not separately identified	65	(34)	43
Net cash provided by continuing operating activities	<u>1,879</u>	<u>2,231</u>	<u>3,692</u>

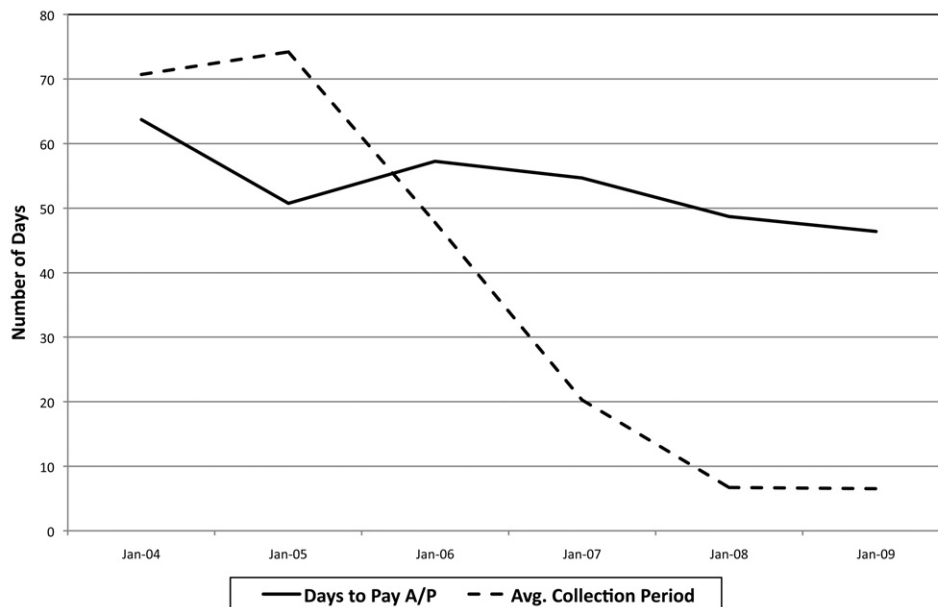
	2008	2007	2006
Cash flows from continuing investing activities:			
Purchase of property and equipment	(761)	(994)	(1,317)
Capitalized software	(136)	(111)	(75)
Proceeds from hurricane insurance claims	68	23	17
Disposition of property and equipment	38	227	679
Proceeds from the disposition of After Hours Formalwear	—	66	—
Proceeds from the disposition of Lord & Taylor	—	—	1,047
Proceeds from the disposition of David's Bridal and Priscilla of Boston	—	—	740
Repurchase of accounts receivable	—	—	(1,141)
Proceeds from the sale of repurchased accounts receivable	—	—	1,323
Net cash provided (used) by continuing investing activities	(791)	(789)	1,273

In many cases it is less expensive to borrow funds with the creditor taking a security interest in accounts receivables and inventory. This would be a loan, not a factoring agreement where the accounts receivable are sold. In a factoring arrangement, the cost to the firm is typically higher.

When receivables are financed through borrowings, it is shown as a finance activity, even though the actions are basically identical to their sale. Also, by factoring, the firm keeps the loan off its balance sheet. Another issue to consider is whether the receivables being sold were done so on a nonrecourse basis so that if they are ultimately uncollectable, Macy's has no further legal obligation. A moral obligation may exist, however, and must be considered.

Figure 3-3 shows Macy's average collection and payables period for the 2003–2009 fiscal years. When Macy's sold about \$ 4.1 billion of its in-house receivables during 2005–2006, it dropped its collection period, but of course, the company paid a price for the immediate cash. It did reduce total debt by about \$1.5 billion, but unfortunately, the company also succumbed to shareholder pressure and expended \$2.5 billion on the repurchase of shares, hopeful the buyback would boost the stock price, which it did not because the company's cash flows were weak.

To Macy's, which had substantially increased its leverage resulting from its \$5.2 billion purchase of May Department Stores the year earlier, the cash resulting from the sale of receivables ultimately might have staved off bankruptcy 2 years later when its business fell owing to the recession and loss of market share to competitors, the latter not an atypical by-product of a large business combination. For sure, management wished the \$2.5 billion stock buyback never took place. The \$2.5 billion outflow robbed Macy's of needed financial flexibility by eliminating a large cushion when its business turned down.

FIGURE 3-3**Macy's Disclosures: Cash Flow from Operating Activities**

While the sale of receivables does indeed provide immediate cash, it is important to consider why the action was taken, especially for companies that operate on tight margins. For such entities, the sale may eliminate the profits those sales initially produced. For them, if the cash is not used to pay down trade payables or other business-related obligations, the analyst must question where such cash eventually will come from. Because Macy's wasted funds from the sale on share buybacks, it cut its purchases of PPE in half over the next 2 years. It is difficult to imagine that a large sale of accounts receivable to buy back shares is ever a good idea.

Example:

CPI Corp. is a leader in professional portrait photography of young children and families, operating 3,108 studios throughout the United States, Canada, Mexico, and Puerto Rico, principally under license agreements with Sears and Wal-Mart. CPI's operating activities show the cash effect and accounting of their pension contribution. CPI expensed approximately \$505,000 million on its income statement during 2008 and \$2 million during 2007 related to the plan, which is reversed under operating cash flows. The company did, however, make an actual cash contribution of \$3,157,000 for fiscal 2009 and approximately \$5 million during 2008, which is reflected under operating activities. Revealed is a supplemental cash payment into the pension plan of \$1,283,000, which was financed through the sale of investments in a rabbi trust, which was recorded as an investment activity. The

rabbi trust was established for company executives.⁹ Also reported under operating activities is the reversal of the noncash income statement expense for stock-based compensation.

For tax-reporting purposes, the exercise or the point of vesting (not granting) of certain stock-based awards often generates a tax-deductible expense regardless of whether the company has been expensing stock-option grants for financial reporting purposes. As specified earlier, tax credits are shown as an operating item on the cash-flow statement under U.S. GAAP only to the extent that they relate to the accounting expense; if the tax deduction exceeds the amount attributable to the accounting expense, such excess is a financing item.

CPI CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
Fifty-Three Weeks Ended February 7, 2009, and Fifty-Two Weeks Ended
February 2, 2008, and February 3, 2007
(In Thousands)

	2008	2007	2006
Reconciliation of net (loss) income to cash flows provided by (used in) operating activities:			
Net (loss) income	\$(7,685)	\$3,576	\$16,327
Adjustments for items not requiring (providing) cash:			
Depreciation and amortization	29,432	27,291	16,861
Loss from discontinued operations	961	441	103
Stock-based compensation expense	1,037	2,724	776
Issuance of common stock to Sears	865	—	—
Loss on impairment of property and equipment	739	—	—
Loss on disposition of property and equipment	1,387	319	220
Deferred income tax provision	(2,550)	1,455	9,357
Pension, supplemental retirement plan, and profit-sharing expense	505	2,009	2,337
Lease guarantee reserve reduction	—	—	(887)
Other	678	683	401

(Continued)

⁹ The *rabbi trust* had its origin in a determination by the Internal Revenue Service (IRS) that an irrevocable trust established for a rabbi by the rabbi's congregation was not subject to current income taxation of the assets because the assets remained subject to the claims of the congregation's general creditors. This ruling was important because, in effect, it permitted a trust to accumulate assets that ultimately would be distributed to a designated person—the participant, in this case the rabbi—without the necessity of the trust or the participant currently paying income taxes on the funds contributed. Further, the assets of the trust are protected from any claims other than those of the employer's general creditors and are otherwise outside the reach of the employer where the trust is irrevocable. The concept was popular as an approach to executive compensation issues, and the IRS was inundated with requests for rulings approving a variety of these so-called rabbi trusts. The IRS responded with the issuance, in 1992, of a Revenue Procedure¹⁵ laying down the requirements of a model rabbi trust, thereby providing detailed guidance for employers who wished to make use of an unfunded deferred compensation arrangement (the rabbi trust technique).

	2008	2007	2006
Increase (decrease) in cash flow from operating assets and liabilities:			
Accounts receivable	4,523	(1,987)	436
Inventories	5,448	2,000	81
Prepaid expenses and other current assets	(1,255)	550	(636)
Accounts payable	(5,153)	6,020	(555)
Contribution to pension plan	(3,157)	(5,050)	—
Supplemental retirement plan payments	(1,283)	(249)	(283)
Accrued expenses and other liabilities	(4,365)	(5,833)	(2,003)
Income taxes payable	(708)	(1,001)	(373)
Deferred revenues and related costs	(7,720)	2,655	(3,118)
Other	964	4,269	(1,051)
Cash flows provided by continuing operations	12,663	39,872	37,993
Cash flows used in discontinued operations	(816)	(406)	(43)
Cash flows provided by operating activities	11,847	39,466	37,950

Next shown are CPI's cash flow provided by investment activities for the years 2006–2008. These transaction into and out of the rabbi trust are reported as investment activities because the assets in the trust are investable assets, as defined under SFAS 95. The \$1.295 million in investments was sold to finance the \$1.283 million supplemental payment listed under operating activities. The reason the amounts do not match is that there were some expenses related to sale of the assets, such as administrative and other fees.

We also see another sale of assets from the rabbi trust of \$1.311 million recorded under investment activities. These funds were not used to pay supplemental or other benefits, but (since we see no other entry related to it) we can assume that those funds were used by the company perhaps as working capital or to fund the underfunded pension plan. Underfunded pension plans, as we will see, can be a significant drain on cash because additional contributions need to take place. Companies making catchup contributions into plans to reduce unfunded obligations that are placed as an operating activity more appropriately should book those payments under financing cash flows because the payment is similar to debt retirement. Originally, the payments should have been considered an operating activity, but once the payments became in arrears, in essence, they became debt financed.

Cash flows (used in) provided by investing activities:

Acquisition of certain net assets of			
Portrait Corporation of America, Inc.,			
net of cash and cash equivalents acquired	(52)	(83,010)	—
Additions to property and equipment	(36,074)	(14,884)	(2,760)
Proceeds from rabbi trust used for supplemental retirement plan payments	1,295	262	295
Distribution of rabbi trust funds in excess of related obligations	1,311	—	—
Other	32	(21)	107

Example:

Palm, Inc., is a manufacturer and marketer of mobile products, primarily cell phones. The following is from the Company's 2009 10K.

PALM, INC.			
CONSOLIDATED STATEMENTS OF CASH FLOWS			
(In Thousands)			
	Years Ended May 31,		
	2009	2008	2007
Cash flows from operating activities:			
Net income (loss)	\$(732,188)	\$(105,419)	\$56,383
Adjustments to reconcile net income (loss) to net cash flows from operating activities:			
Depreciation	19,677	19,699	13,316
Stock-based compensation	23,853	32,181	24,255
Amortization of intangible assets	12,134	16,510	8,315
Amortization of debt issuance costs	3,139	1,834	—
In-process research and development	—	—	3,700
Deferred income taxes	401,670	(58,227)	11,313
Realized (gain) loss on short-term investments	3,594	(68)	(110)
Excess tax benefit related to stock-based compensation	(142)	(40)	(5,241)
Realized loss (gain) on disposition of property and equipment and sale of land	619	(4,446)	—
Impairment of noncurrent auction-rate securities	35,885	32,175	—
Loss on Series C derivative	2,515	—	—
Changes in assets and liabilities:			
Accounts receivable	48,425	89,312	2
Inventories	47,571	(28,147)	18,842
Prepays and other	4,542	736	1,790
Accounts payable	(54,883)	(35,840)	11,654
Income taxes payable	(346)	3,033	16,421
Accrued restructuring	(361)	6,303	(1,803)
Deferred revenues/costs, net	12,530	—	—
Other accrued liabilities	(16,746)	12,866	9,354
Net cash provided by (used in) operating activities	(188,512)	(17,538)	168,191

In 2009, after 2 years of losses, Palm, Inc., management decided to take the full deferred income tax valuation allowance against its deferred tax asset. While this had no effect on current operating cash flow, it reduced shareholders' equity on the balance sheet. The \$401,670 deferred

income taxes under operating cash flows is a reversal of the income-statement entry. Also, while Palm has a large tax loss carryover for federal purposes, its income tax footnote reveals that it is paying both state and foreign income taxes.

Palm also recognized a loss on its investment in auction-rate securities owing to the issuer's failure to pay interest in a timely manner. The cash effect was reversed under operating activities because there is no cash impact. There is a valuation and equity impact because those assets have become of questionable value.

Example:

QAD, Inc., is a global software company. In its July 2006 10Q, QAD reported slightly lower cash flow from operations owing to a decline in deferred revenues and other liabilities (\$1.2 million from the prior year) that, according to the company's 10K, represented a change in severance pay accruals. The company stepped up its collection efforts, as manifested by the cash provided by accounts receivables. Also reported is an increase in stock compensation expense, which preserved cash.

	Six Months Ended July 31 (\$000)	
	2006	2005
Cash flows from operating activities:		
Net income	\$2,529	\$6,350
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,598	3,802
Provision for doubtful accounts and sales adjustments	189	(168)
(Gain) loss on disposal of property and equipment	9	(20)
Tax benefit from reversal of tax allowances and reserves	—	(373)
Exit costs	355	940
Stock compensation expense	2,596	55
Other, net	(39)	(107)
Changes in assets and liabilities, net of effects from acquisitions:		
Accounts receivable	20,024	17,680
Other assets	517	1,973
Accounts payable	(2,657)	(2,633)
Deferred revenue	(12,788)	(11,934)
Other liabilities	(4,098)	(2,884)
Net cash provided by operating activities	10,235	12,681

Source: QAD 10Q, July 31, 2006.

Example:

Phelps Dodge made a large contribution to its Voluntary Employee Benefit Association (VEBA)¹⁰ and pension plans in 2005. Also seen is the effect of its copper protection programs, or copper "collars," under which the company uses both put and calls options to lock in price guarantees for its output. During 2006, a large run-up in the price of copper resulted in a large loss on these hedges, which was made up, and more, from higher price realization for the metal. Phelps Dodge also points out, in their 2006 10K, that it hedged 486 million pounds, its expected output for the following year.

Given the loss on the collar, was Phelps Dodge happy that it had hedged? Probably. Look at it this way: If you were happy to sell your house for \$500,000 and someone was willing to pay you \$50,000 for the right to buy it for \$750,000 over the next year, you might do it. And if the option were taken advantage of, you would both be happy. Of course, if the price of the house dropped to \$300,000, you might not be so happy, even though you got to keep the \$50,000.

Also of note is the large increase in minority interests. Phelps Dodge owns minority interests in companies located around the world, accounted for on an equity basis. In some geographic areas, the governments do not permit ownership above a fixed percentage. During 2006, minority interest benefited from higher commodity prices, and the value of those assets reflected the rise. The amounts included under operating activities merely reverse those entries on the income statement because it is noncash, and the amount was already debited on the income statement.

Phelps Dodge also recorded \$54 million in "early debt extinguishment costs" the prior year as a gain on its income statement, so it was reversed under operating activities. The entry resulted from the company completing a tender offer for debt having a book value of approximately \$280 million. That purchase (\$280 million plus the \$54 million) would be seen as a financing activity (section not shown). Phelps Dodge, in its 10K, estimated that the prepayment of this debt would reduce its pretax annual interest expense by about \$24 million.

Operating activities:

Net income	\$3,017.8	1,556.4	1,046.3
Adjustments to reconcile net income to net cash provided by operating activities:			
Losses on copper collars and copper put options (realized but unpaid and unrealized)	1,008.9	410.5	—
Depreciation, depletion, and amortization	449.0	490.9	507.1
Deferred income tax provision (benefit)	(147.0)	16.4	(17.8)
Equity in net earnings (losses) of affiliated companies, net of dividends received	(1.9)	(0.1)	2.2
Gain on sale of cost-basis investment, net of expenses	—	(438.4)	—
Change in interest gains, net of expenses	—	(168.3)	—
Special items and provisions, net	93.6	612.1	59.9
Early debt extinguishment costs	—	54.0	43.2

(Continued)

¹⁰ A VEBA is a specialized tax-free health care trust fund that will pay for the future benefit costs of a company's current or retired workers. VEBAs were created in the 1920s after many large employers defaulted on promised benefits. In a VEBA, the employer makes a tax-free contribution to a trust fund, which also grows tax-free. Since these funds are outside the control of the company, they release the firm from such liabilities.

Minority interests in consolidated subsidiaries	792.7	190.6	201.8
Loss on disposition of discontinued operations	30.3	5.8	—
Cumulative effect of accounting changes	—	13.5	—
Changes in current assets and liabilities:			
Accounts receivable	(236.1)	(399.0)	(276.2)
Repayment of securitized accounts receivable	—	(85.0)	—
Mill and leach stockpiles	(50.1)	(10.5)	1.0
Inventories	(0.7)	(46.5)	(0.4)
Supplies	(48.8)	(33.8)	(23.6)
Prepaid expenses and other current assets	(36.4)	(35.2)	(6.7)
Interest payable	1.1	(3.8)	(8.2)
Other accounts payable	21.7	159.6	212.1
Accrued income taxes	401.9	(0.9)	17.5
Realized losses on 2005 copper collars	(187.2)	—	—
Other accrued expenses	(9.9)	(97.9)	(42.8)
Master trust pension plan contributions	—	(250.0)	(85.4)
VEBA trust contributions	—	(200.0)	—
Other operating, net	(19.7)	29.3	70.1
Net cash provided by operating activities	5,079.2	1,769.7	1,700.1

Source: Phelps Dodge 2006 10K.

Example:

When a firm acquires or disposes of a significant business asset, the analyst should be careful interpreting the relevant items on the statement of cash flows because the amounts shown might represent only a portion of the transaction that involved cash payments or receipts. The entire transaction may have involved a much larger amount because many business combinations include stock, deferred payments, or other expenses as part of the transaction. For example, the merger agreement may indemnify the acquirer against certain risks by providing for backstop payments.

In 2008, Finisar Corp., a leading provider of optical subsystems, completed a business combination with Optimum, a designer of high-performance optical subsystems for the cable industry, in an all-stock transaction in exchange for 160,808,659 shares of its stock, which (valued at closing) was worth approximately \$242.8 million. The transaction consisted of \$150 million of goodwill. Because Finisar management decided to eliminate all goodwill from its balance sheet, the \$88 million, along with the goodwill of a previous business acquisition, totaling (\$238.5 million), was reversed under operating activities from the income-statement expense. Because it was a stock deal, no cash outlay is reflected in the statement of cash flows.

In a business combination, vested stock options or awards issued by an acquirer in exchange for outstanding awards held by the target's employees are considered to be part of the purchase price and accounted for under SFAS 141R. Accordingly, the fair value of the new replacement awards is included in the purchase price. Unvested stock options or awards granted by an acquirer in exchange for stock options or awards held by the target's employees are also considered part of the purchase price, with the fair value of the new replacement awards included in the purchase price. Unearned compensation is recorded as an asset on the balance sheet and is amortized over the remaining future service (vesting) period.

Under operating activities, Finisar points out in its 10K, deferred income taxes decreased mainly because of a reversal of previously recorded deferred tax liabilities as a result of the impairment of goodwill. Stock-based compensation is added to operating activities because it represents stock compensation (grants not yet exercised) to employees expensed at fair value but is noncash. Cash will not change hands until the options are exercised. It should be expected that pressure from shareholders and Congress and the associated liquidity savings of noncash compensation will align the owners of capital and firms' employees such that stock-based compensation will continue to grow over the coming years.¹¹

FINISAR CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Fiscal Years Ended April 30 (In Thousands)		
	2009	2008	2007
Operating activities:			
Net loss	\$(254,808)	\$(74,558)	\$(48,908)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Depreciation and amortization	30,490	25,377	25,047
Stock-based compensation expense	14,978	11,564	11,822
Acquired in-process research and development	10,500	—	5,770
Amortization of beneficial conversion feature of convertible notes	1,817	4,943	4,791
Amortization of purchased technology and finite-lived intangibles	2,687	1,749	1,814
Impairment of goodwill and intangible assets	238,507	40,106	—
Impairment of acquired developed technology	1,248	—	—
Amortization of acquired developed technology	6,038	6,501	6,002
Amortization of discount on restricted securities	—	(11)	(92)
Loss (gain) on sales of equipment	996	(516)	1,214
Other than temporary decline in fair market value of equity security	1,920	—	—
Gain on sale of minority investment	—	—	(1,198)
Loss on convertible debt exchange	—	238	31,606
Gain on repurchase of convertible debt	(3,838)	—	—
Loss on sale of product line	919	—	—
Loss (gain) on remeasurement of derivative liability	(1,135)	1,135	—
Share of losses of equity investee	—	—	237
Loss on sale of equity investment	12	15	—

(Continued)

¹¹Succumbing to such pressure, Goldman Sachs, a recipient of TARP funds, announced that its top executives would receive stock in lieu of cash bonus compensation for 2009.

	Fiscal Years Ended April 30		
	(In Thousands)		
	2009	2008	2007
Changes in operating assets and liabilities:			
Accounts receivable	(33,399)	8,891	2,449
Inventories	459	(1,159)	(17,364)
Other assets	922	(5,496)	(333)
Deferred income taxes	(7,277)	1,756	2,176
Accounts payable	4,396	1,432	3,227
Accrued compensation	(4,611)	3,847	(737)
Other accrued liabilities	(9,759)	9,021	113
Deferred revenue	(680)	(214)	1,375
Net cash provided by operating activities	<u>382</u>	<u>34,621</u>	<u>29,011</u>
Investing activities:			
Purchases of property, equipment, and improvements	(23,918)	(27,198)	(22,340)
Purchases of short- and long-term investments	(4,125)	(84,236)	(164,796)
Sale/maturity of short- and long-term investments	42,567	115,051	153,141
Maturity of restricted securities	—	625	4,951
Acquisition of subsidiaries, net of cash acquired	30,137	521	(10,708)
Proceeds from sale of property and equipment	229	643	512
Proceeds from sale of minority investment	—	—	1,198
Proceeds from sale of equity investment	90	1,569	—
Purchases of minority investments	—	(2,000)	—
Net cash provided by (used in) investing activities	<u>44,980</u>	<u>4,975</u>	<u>(38,042)</u>
Financing activities:			
Repurchase of convertible notes	(95,956)	(8,224)	—
Repayment of convertible notes related to acquisition	(11,918)	(5,959)	—
Proceeds from term loan and revolving line of credit	20,000	—	—
Repayments of liability related to sale-leaseback of building	(101)	(359)	(296)
Repayments of borrowings under notes	(4,225)	(1,897)	(2,036)
Proceeds from exercise of stock options, warrants, and stock purchase plan, net of repurchase of unvested shares	4,525	179	4,108
Net cash provided by (used in) financing activities	<u>(87,675)</u>	<u>(16,260)</u>	<u>1,776</u>
Net increase (decrease) in cash and cash equivalents	(42,313)	23,336	(7,255)
Cash and cash equivalents at beginning of year	79,442	56,106	63,361
Cash and cash equivalents at end of year	<u>\$37,129</u>	<u>\$79,442</u>	<u>\$56,106</u>
Supplemental disclosure of cash-flow information:			
Cash paid for interest	\$6,776	\$9,190	\$9,514
Cash paid for taxes	\$1,100	\$182	\$659

	Fiscal Years Ended April 30 (In Thousands)		
	2009	2008	2007
Supplemental schedule of noncash investing and financing activities:			
Issuance of convertible promissory note on acquisition of subsidiary	\$—	\$—	\$16,950
Issuance of common stock in connection with acquisitions	\$242,821	\$—	\$—

Example:

Unifi, Inc., is a diversified producer and processor of multifilament polyester and nylon yarns. The operating activity section is taken from their 2009 10K. As seen, Unifi reports under the direct method of reporting cash flow from operations along with the indirect method as is required.

Several observations are worth noting. Receipts from customers fell considerably (owing to lower sales). Concurrently, we see lower payments to suppliers. The ratio of payments to suppliers and other operating costs as a percentage of cash receipts fell to 75.5 percent from 77.5 percent in 2008, indicating that management was “working” the balance sheet and controlling expenditures as business softened. We indeed see that this is the case, as shown by the indirect approach because the company collected accounts receivable at a quicker pace, which, together with a significant reduction in inventories of \$27.7 million, added about \$46.5 million to operating activities. This was offset in part by a slight increase in other assets and a \$27.3 million reduction in accounts payable. We also see in the indirect approach an \$18.6 million noncash effect of goodwill impairment that would not appear under the direct model. Noncash items are not included in the direct approach.

UNIFI, INC.
STATEMENT OF CASH FLOWS USING THE DIRECT APPROACH

	Fiscal Years Ended (In Millions)		
	June 28, 2009	June 29, 2008	June 24, 2007
Cash provided by continuing operations:			
Cash receipts:			
Receipts from customers	\$572.6	\$708.7	\$691.8
Dividends from unconsolidated affiliates	3.7	4.5	2.7
Other receipts	2.7	6.5	4.3
Cash payments:			
Payments to suppliers and other operating cost	432.3	549.4	530.5
Payments for salaries, wages, and benefits	99.9	117.2	130.3
Payments for restructuring and severance	4.0	11.2	1.6
Payments for interest	22.6	25.3	23.1
Payments for taxes	3.2	2.9	2.7
Cash provided by continuing operations	\$17.0	\$13.7	\$10.6

(Continued)

UNIFI, INC.
STATEMENT OF CASH FLOWS USING THE INDIRECT APPROACH

	Fiscal Years Ended (In Thousands)		
	June 28, 2009	June 29, 2008	June 24, 2007
Cash and cash equivalents at beginning of year	\$20,248	\$40,031	\$35,317
Operating activities:			
Net loss	(48,996)	(16,151)	(115,792)
Adjustments to reconcile net loss to net cash provided by continuing operating activities:			
Income from discontinued operations	(65)	(3,226)	(1,465)
Net (earnings) loss of unconsolidated affiliates, net of distributions	437	3,060	7,029
Depreciation	28,043	36,931	41,594
Amortization	4,430	4,643	3,264
Stock-based compensation expense	1,425	1,015	1,691
Deferred compensation expense, net	165	—	1,619
Net gain on asset sales	(5,856)	(4,003)	(1,225)
Noncash portion of (gain) loss on extinguishment of debt	(251)	—	25
Noncash portion of restructuring charges (recoveries), net	91	4,027	(157)
Noncash write-down of long-lived assets	350	2,780	16,731
Noncash effect of goodwill impairment	18,580	—	—
Noncash write-down of investment in unconsolidated affiliates	1,483	10,998	84,742
Deferred income tax	360	(15,066)	(23,776)
Provision for bad debts	2,414	214	7,174
Other	400	(8)	(866)
Changes in assets and liabilities, excluding effects of acquisitions and foreign currency adjustments:			
Receivables	18,781	(5,163)	(2,522)
Inventories	27,681	14,144	5,619
Other current assets	(5,329)	1,641	187
Accounts payable and accrued expenses	(27,283)	(22,525)	(12,158)
Income taxes payable	100	362	(1,094)
Net cash provided by continuing operating activities	16,960	13,673	10,620

Source: Unifi Corp. 2009 10K.

Example:

Standex International is a manufacturer of a variety of products and services for diverse industrial market segments. The company has 12 operating segments, aggregated and organized for reporting purposes into 5 segments: Food Service Equipment Group, Air Distribution Products Group (ADP), Engraving Group, Engineering Technologies Group, and Electronics and Hydraulics Group. The company reports its cash flow from operating activities as follows:

STANDEX INTERNATIONAL CORPORATION AND SUBSIDIARIES
STATEMENT OF CONSOLIDATED CASH FLOWS

	For the Years Ended June 30 (In Thousands)		
	2009	2008	2007
Cash flows from operating activities:			
Net income (loss)	(\$5,405)	\$18,510	\$21,242
Income (loss) from discontinued operations	(3,515)	(774)	5,317
Income (loss) from continuing operations	(1,890)	19,284	15,925
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	15,541	17,113	15,198
Stock-based compensation	2,398	2,437	385
Deferred income taxes	(3,563)	(467)	(1,133)
Impairment charges	21,339	—	—
Noncash portion of restructuring charge	3,730	94	—
(Gain) loss on sale of investments, real estate and equipment, and debt extinguishment	375	(344)	(1,023)
Increase (decrease) in cash from changes in assets and liabilities, net of effects from discontinued operations and business acquisitions:			
Accounts receivables, net	18,360	4,738	(1,591)
Inventories	11,605	4,299	(4,261)
Contributions to defined benefit plans	—	(620)	(3,862)
Prepaid expenses and other	1,001	471	1,277
Accounts payable	(6,034)	(912)	8,378
Accrued payroll, employee benefits, and other liabilities	(18,039)	836	1,151
Income taxes payable	(1,550)	(1,746)	2,053
Net cash provided by operating activities—continuing operations	43,273	45,183	32,497
Net cash (used in)/provided by operating activities—discontinued operations	(3,829)	(477)	(7,002)
Net cash provided by operating activities	39,444	44,706	25,495

(Continued)

Standex reports a large impairment charge under the section. The test for impairment is a two-step process. The first step compares the carrying amount of the reporting unit with its estimated fair value. To the extent that the carrying value of the reporting unit exceeds its estimated fair value, a second step is performed, wherein the reporting unit's carrying value is compared with the implied fair value. To the extent that the carrying value exceeds the implied fair value, impairment exists and must be recognized. If the book value of assets falls below the discounted present value of cash flows, a charge may be necessary.

Since the \$21.3 million is already expensed in the income statement, the entry needs to be reversed because it represents a write-off of cash that previously flowed through the statement of cash flows when the asset was acquired—there is no current direct cash-flow impact. While this represents a noncash restructuring charge, to the extent that investors believed the asset would return free cash flow, the charge-off represents a diminishment in expectations as well as a change in the stability of prospective business results.

Example:

99¢ Only Stores is a low-price retailer of consumable general merchandise with an emphasis on name-brand products selling primarily at 99 cents or less. 99¢ Only Stores has (1) been profitable in each of the past 10 years, (2) has no meaningful debt outside normal trade and operating leases, and (3) has had higher operating cash flows than net income in each year. The purpose of the example is a representation of the substantial number of entities that report the ratio of operating activities to net income, representing the quotient as a quasi-cash conversion cycle metric. As a matter of fact, it is not unusual to find such a table in 10Ks and company investor presentations with an implicit representation that the ability to show greater operating cash flows than net income indicates that net income is not capturing the real value of the enterprise or even perhaps that it is a superior free-cash-flow-producing entity.

As seen in this example, despite 99¢ Only Stores' large plowback of earnings into capital spending, resulting in high depreciation expense, the company has not, for the decade under inspection, been able to turn this into growth in free cash flow, and hence its market value has fallen. We see in Table 3-2 its 3-year average free cash flow, which includes overspending on discretionary areas (explained in Chapter 4), lower for 2007–2009 than the 3-year average of 1998–2000.

Regarding the tax credits related to share based compensation, as mentioned earlier, they are shown as an operating item only to the extent that they relate to the accounting expense; such excess is a financing item. When a company grants share-based awards, generally no cash is paid or received. Cash-flow consequences, if any, only arise when the options are exercised (e.g., as a result of payment of the exercise price and from associated tax benefits). For some other grants such as stock appreciation rights (SARs) payable in shares and restricted share grants, no cash changes hands at all.

99¢ ONLY STORES
CONSOLIDATED STATEMENTS OF CASH FLOWS (In Thousands)

	Years Ended		
	March 28, 2009	March 29, 2008	March 31, 2007
Cash flows from operating activities:			
Net income	\$8,481	\$2,893	\$9,762

	Years Ended		
	March 28, 2009	March 29, 2008	March 31, 2007
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	34,266	33,321	32,675
Loss on disposal of fixed assets	791	124	171
Gain on sale of partnerships	(706)	—	—
Fixed assets impairment	10,355	531	—
Fixed investments impairment	1,677	—	—
Minority interest in partnership	1,357	—	—
Excess tax deficiency (benefit) from share-based payment arrangements	10	(130)	(645)
Deferred income taxes	(11,419)	(11,024)	(5,934)
Stock-based compensation expense	3,136	4,184	5,224
Tax benefit from exercise of nonqualified employee stock options	—	263	1,032
Changes in assets and liabilities associated with operating activities:			
Accounts receivable	(346)	543	506
Inventories	(11,617)	13,750	(11,887)
Deposits and other assets	(435)	3,031	(3,533)
Accounts payable	10,619	(5,676)	(9,398)
Accrued expenses	11,678	1,644	4,672
Accrued workers' compensation	1,550	(673)	(738)
Income taxes	1,551	72	6,013
Deferred rent	(345)	2,343	586
Other long-term assets	2,339	—	—
Net cash provided by operating activities	62,942	45,196	28,506
Cash flows from investing activities:			
Purchases of property and equipment	(34,222)	(54,388)	(47,007)

TABLE 3-2

99¢ Only Stores Comparison of Fundamental Data

December Year End	Net Income (Loss)	Operating Cash Flow	Free Cash Flow	Capital Expenditures	Depreciation	Market Value
1998	27	27	21	13	5	—
1999	22	26	10	18	6	958
2000	38	50	31	27	9	937
2001	48	67	38	47	12	1,983
2002	59	72	38	42	18	1,883
2003	57	80	11	99	24	1,942
2004	28	94	54	57	28	1,123

(Continued)

TABLE 3-2 (Continued)**99¢ Only Stores Comparison of Fundamental Data**

December Year End	Net Income (Loss)	Operating Cash Flow	Free Cash Flow	Capital Expenditures	Depreciation	Market Value
2005	11	83	57	48	31	943
2006	10	29	(1)	47	33	1,030
2007	3	45	5	54	33	693
2008	8	63	32	34	34	646
Total	311	636	295	485	233	—

Example:

Berkshire Hathaway, in its 10Qs, shows its net cash flows from operating activities as a single-line entry.¹² It therefore would behoove the analyst to prepare a more detailed presentation, working through the changes in the balance sheet and other operating items affecting operating activities. The largest item, as reported on the company's balance sheet, is the \$2.3 billion gain on derivative contracts, which is merely an adjustment to the liability section and a reflection of the large rise in the equity market on which the underlying contracts are based (over the prior period). This would not be shown in the direct-method presentation but would if an indirect worksheet were constructed. Loss and loss adjustment expenses, depreciation, and changes in other assets and liabilities typically would be the largest items on the worksheet, aside from investment gains and losses and changes in derivative contract assets and liabilities.

Berkshire sold a large number of long-term put contracts, collected the cash premium, and now must report the quarterly net changes in the income and cash-flow statements and reflected in the balance sheet as part of other assets and liabilities. These entries represent an adjustment to the value of the derivative contracts—if no cash changes hands, that amount would be reversed under operating activities. To the extent that Berkshire either sold additional put contracts or changed the maturity date or strike price of the options, it would, and actually did, collect cash during the quarter that would be reflected under operating activities.

It is necessary to thoroughly review the footnote related to derivative positions to grasp the potential risks to cash flow and leverage ratios, especially a worst-case scenario whereby the contract prices went against the holder. In this analysis, one should determine what various scenarios (sensitivity analysis) would mean to shareholders' equity and related loan covenants.

In Berkshire's case, we see that this increased the company's exposure throughout 2008 and 2009. Berkshire's derivatives do not meet the criteria of hedging contracts, so changes flow through the income statement.

¹²Regulation S-X, Rule 10-01: Interim Financial Statements:

- (a) *Condensed statements.* Interim financial statements shall follow the general form and content of presentation prescribed by the other sections of this Regulation with the following exceptions:
- (4) *The statement of cash flows may be abbreviated starting with a single figure of net cash flows from operating activities* and showing cash changes from investing and financing activities individually only when they exceed 10 percent of the average of net cash flows from operating activities for the most recent three years. Notwithstanding this test, Rule 4-02 applies, and de minimis amounts therefore need not be shown separately.

Unlike the June 2009 10Q filing, Berkshire, in its 2008 10K, delineates cash flows from operating activities, and as reported, the largest contributor affecting operating cash flows is derivative contract assets and liabilities. The amount in the statement of cash flows almost fully offsets the gain in the "P&L," but not fully, indicating that Berkshire realized cash of approximately \$1 billion, reflecting premiums received for selling these additional derivative contracts and changes in the (maturity) terms on existing contracts. However, this cash didn't come without additional risk, as the company indicated in its derivatives footnote, which shows a large increase in liabilities and notational value (see 2008 balance sheet and footnote). This unrealized loss caused a drop in shareholders' (book value) equity; no cash impact would be felt until the contracts were settled.

BERKSHIRE HATHAWAY, INC., AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Millions)

	First 6 Months (Unaudited)	
	2009	2008
Net cash flows from operating activities:	\$7,497	\$4,991
Cash flows from investing activities:		
Purchases of fixed maturity securities	(7,450)	(26,754)
Purchases of equity securities	(974)	(5,513)
Purchases of other investments	(6,068)	—
Sales of fixed-maturity securities	2,282	11,950
Redemptions and maturities of fixed-maturity securities	2,716	6,807
Sales of equity securities	1,343	1,764
Purchases of loans and finance receivables	(148)	(1,045)
Principal collections on loans and finance receivables	356	370
Acquisitions of businesses	(221)	(5,424)
Purchases of property, plant, and equipment	(2,633)	(2,538)
Other	1,156	959
Net cash flows from investing activities	(9,641)	(19,424)
Cash flows from financing activities:		
Proceeds from borrowings of finance businesses	1,504	4,118
Proceeds from borrowings of utilities and energy businesses	992	1,047
Proceeds from other borrowings	58	84
Repayments of borrowings of finance businesses	(216)	(2,602)
Repayments of borrowings of utilities and energy businesses	(230)	(1,120)
Repayments of other borrowings	(306)	(133)
Change in short-term borrowings	(339)	(107)
Acquisitions of noncontrolling interests and other	(387)	(31)
Net cash flows from financing activities	1,076	1,256
Effects of foreign currency exchange-rate changes	40	7
Decrease in cash and cash equivalents	(1,028)	(13,170)
Cash and cash equivalents at beginning of year	25,539	44,329
Cash and cash equivalents at end of first 6 months	\$24,511	\$31,159

(Continued)

BERKSHIRE HATHAWAY, INC., AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Millions, Unaudited)

	June 30, 2009	December 31, 2008
Assets:		
Insurance and other:		
Cash and cash equivalents	\$21,439	\$24,302
Investments:		
Fixed maturity securities	32,018	27,115
Equity securities	45,794	49,073
Other	30,365	21,535
Receivables	15,778	14,925
Inventories	6,387	7,500
Property, plant, and equipment	17,016	16,703
Goodwill	27,535	27,477
Other	13,306	13,257
	<u>209,638</u>	<u>201,887</u>
Utilities and energy:		
Cash and cash equivalents	875	280
Property, plant, and equipment	29,987	28,454
Goodwill	5,363	5,280
Other	5,597	7,556
	<u>41,822</u>	<u>41,570</u>
Finance and financial products:		
Cash and cash equivalents	2,197	957
Investments in fixed-maturity securities	4,150	4,517
Loans and finance receivables	13,631	13,942
Goodwill	1,024	1,024
Other	3,184	3,502
	<u>24,186</u>	<u>23,942</u>
	<u>\$275,646</u>	<u>\$267,399</u>
Liabilities and shareholders' equity:		
Insurance and other:		
Losses and loss adjustment expenses	\$58,867	\$56,620
Unearned premiums	8,831	7,861
Life and health insurance benefits	3,898	3,619
Accounts payable, accruals, and other liabilities	14,676	14,987
Notes payable and other borrowings	4,379	4,349
	<u>90,651</u>	<u>87,436</u>

	June 30, 2009	December 31, 2008
Utilities and energy:		
Accounts payable, accruals, and other liabilities	5,800	6,175
Notes payable and other borrowings	19,708	19,145
	<u>25,508</u>	<u>25,320</u>
Finance and financial products:		
Accounts payable, accruals, and other liabilities	2,580	2,656
Derivative contract liabilities	12,299	14,612
Notes payable and other borrowings	14,697	13,388
	<u>29,576</u>	<u>30,656</u>
Income taxes, principally deferred	11,074	10,280
Total liabilities	<u>156,809</u>	<u>153,692</u>
Shareholders' equity:		
Common stock and capital in excess of par value	27,089	27,141
Accumulated other comprehensive income	7,505	3,954
Retained earnings	79,933	78,172
	<u>114,527</u>	<u>109,267</u>
Berkshire Hathaway shareholders' equity	114,527	109,267
Noncontrolling interests	4,310	4,440
	<u>118,837</u>	<u>113,707</u>
Total shareholders' equity	<u>118,837</u>	<u>113,707</u>
	<u>\$275,646</u>	<u>\$267,399</u>

BERKSHIRE HATHAWAY, INC., AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In Millions Except Per-Share Amounts)

	December 31,	
	2008	2007
Assets:		
Insurance and other:		
Cash and cash equivalents	\$24,302	\$37,703
Investments:		
Fixed-maturity securities	27,115	28,515
Equity securities	49,073	74,999
Other	21,535	—

(Continued)

	December 31,	
	2008	2007
Loans and receivables	14,925	13,157
Inventories	7,500	5,793
Property, plant, equipment, and assets held for lease	16,703	9,969
Goodwill	27,477	26,306
Deferred charges, reinsurance assumed	3,923	3,987
Other	9,334	7,797
	<u>201,887</u>	<u>208,226</u>
Utilities and energy:		
Cash and cash equivalents	280	1,178
Property, plant, and equipment	28,454	26,221
Goodwill	5,280	5,543
Other	7,556	6,246
	<u>41,570</u>	<u>39,188</u>
Finance and financial products:		
Cash and cash equivalents	957	5,448
Investments in fixed-maturity securities	4,517	3,056
Loans and finance receivables	13,942	12,359
Goodwill	1,024	1,013
Other	3,502	3,870
	<u>23,942</u>	<u>25,746</u>
	<u>\$267,399</u>	<u>\$273,160</u>
Liabilities and shareholders' equity:		
Insurance and other:		
Losses and loss adjustment expenses	\$56,620	\$56,002
Unearned premiums	7,861	6,680
Life and health insurance benefits	3,619	3,804
Other policyholder liabilities	3,243	4,089
Accounts payable, accruals, and other liabilities	11,744	10,672
Notes payable and other borrowings	4,349	2,680
	<u>87,436</u>	<u>83,927</u>
Utilities and energy:		
Accounts payable, accruals, and other liabilities	6,303	6,043
Notes payable and other borrowings	19,145	19,002
	<u>25,448</u>	<u>25,045</u>

	December 31,	
	2008	2007
Finance and financial products:		
Accounts payable, accruals, and other liabilities	2,656	2,931
Derivative contract liabilities	14,612	6,887
Notes payable and other borrowings	13,388	12,144
	<u>30,656</u>	<u>21,962</u>
Income taxes, principally deferred	10,280	18,825
Total liabilities	<u>153,820</u>	<u>149,759</u>
Minority shareholders' interests	4,312	2,668
Shareholders' equity:		
Common stock: Class A, \$5 par value; Class B, \$0.1667 par value	8	8
Capital in excess of par value	27,133	26,952
Accumulated other comprehensive income	3,954	21,620
Retained earnings	78,172	72,153
Total shareholders' equity	<u>109,267</u>	<u>120,733</u>
	<u>\$267,399</u>	<u>\$273,160</u>

BERKSHIRE HATHAWAY, INC., AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS
(In Millions Except Per-Share Amounts)

	Year Ended December 31,		
	2008	2007	2006
Revenues:			
Insurance and other:			
Insurance premiums earned	\$25,525	\$31,783	\$23,964
Sales and service revenues	65,854	58,243	51,803
Interest, dividend, and other investment income	4,966	4,979	4,382
Investment gains/losses	(647)	5,405	1,697
	<u>95,698</u>	<u>100,410</u>	<u>81,846</u>

(Continued)

	Year Ended December 31,		
	2008	2007	2006
Utilities and energy:			
Operating revenues	12,668	12,376	10,301
Other	1,303	252	343
	<u>13,971</u>	<u>12,628</u>	<u>10,644</u>
Finance and financial products:			
Interest income	1,790	1,717	1,610
Investment gains/losses	7	193	114
Derivative gains/losses	(6,821)	(89)	824
Other	3,141	3,386	3,501
	<u>(1,883)</u>	<u>5,207</u>	<u>6,049</u>
	<u>107,786</u>	<u>118,245</u>	<u>98,539</u>
Costs and expenses:			
Insurance and other:			
Insurance losses and loss adjustment expenses	16,259	21,010	13,068
Life and health insurance benefits	1,840	1,786	1,618
Insurance underwriting expenses	4,634	5,613	5,440
Cost of sales and services	54,103	47,477	42,416
Selling, general, and administrative expenses	8,052	7,098	5,932
Interest expense	156	164	195
	<u>85,044</u>	<u>83,148</u>	<u>68,669</u>
Utilities and energy:			
Cost of sales and operating expenses	9,840	9,696	8,189
Interest expense	1,168	1,158	979
	<u>11,008</u>	<u>10,854</u>	<u>9,168</u>
Finance and financial products:			
Interest expense	639	588	550
Other	3,521	3,494	3,374
	<u>4,160</u>	<u>4,082</u>	<u>3,924</u>
	<u>100,212</u>	<u>98,084</u>	<u>81,761</u>
Earnings before income taxes and minority interests:			
Income taxes	1,978	6,594	5,505
Minority shareholders' interests	602	354	258
	<u>\$4,994</u>	<u>\$13,213</u>	<u>\$11,015</u>
Net earnings:	<u>\$4,994</u>	<u>\$13,213</u>	<u>\$11,015</u>
Average common shares outstanding	1,548,960	1,545,751	1,541,807
Net earnings per common share:	<u>\$3,224</u>	<u>\$8,548</u>	<u>\$7,144</u>

BERKSHIRE HATHAWAY, INC., AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Millions)

	Year Ended December 31,		
	2008	2007	2006
Cash flows from operating activities:			
Net earnings	\$4,994	\$13,213	\$11,015
Adjustments to reconcile net earnings to operating cash flows:			
Investment (gains) losses	640	(5,598)	(1,811)
Depreciation	2,810	2,407	2,066
Minority interests	602	354	258
Other	(1,248)	(268)	(627)
Changes in operating assets and liabilities before business acquisitions:			
Losses and loss adjustment expenses	1,466	(1,164)	(2,704)
Deferred charges reinsurance assumed	64	196	424
Unearned premiums	1,311	(713)	637
Receivables and originated loans	(2,222)	(977)	(59)
Derivative contract assets and liabilities	7,827	2,938	(563)
Income taxes	(2,057)	553	303
Other assets and liabilities	(2,935)	1,609	1,256
Net cash flows from operating activities	<u>11,252</u>	<u>12,550</u>	<u>10,195</u>
Cash flows from investing activities:			
Purchases of fixed-maturity securities	(35,615)	(13,394)	(7,747)
Purchases of equity securities	(10,140)	(19,111)	(9,173)
Purchases of other investments	(14,452)	—	—
Sales of fixed-maturity securities	14,796	7,821	1,818
Redemptions and maturities of fixed-maturity securities	18,550	9,158	10,313
Sales of equity securities	6,840	8,054	3,778
Purchases of loans and finance receivables	(1,446)	(1,008)	(365)
Principal collections on loans and finance receivables	740	1,229	985
Acquisitions of businesses, net of cash acquired	(6,050)	(1,602)	(10,132)
Purchases of property, plant, and equipment and assets held for lease	(6,138)	(5,373)	(4,571)
Other	849	798	1,017
Net cash flows from investing activities	<u>(32,066)</u>	<u>(13,428)</u>	<u>(14,077)</u>

(Continued)

	Year Ended December 31,		
	2008	2007	2006
Cash flows from financing activities:			
Proceeds from borrowings of finance businesses	5,195	1,153	1,280
Proceeds from borrowings of utilities and energy businesses	2,147	3,538	2,417
Proceeds from other borrowings	134	121	215
Repayments of borrowings of finance businesses	(3,861)	(1,093)	(244)
Repayments of borrowings of utilities and energy businesses	(2,147)	(1,149)	(516)
Repayments of other borrowings	(233)	(995)	(991)
Changes in short-term borrowings	1,183	(596)	245
Other	(132)	387	84
Net cash flows from financing activities	2,286	1,366	2,490
Effects of foreign currency exchange-rate changes	(262)	98	117
Increase (decrease) in cash and cash equivalents	(18,790)	586	(1,275)
Cash and cash equivalents at beginning of year	44,329	43,743	45,018
Cash and cash equivalents at end of year*	\$25,539	\$44,329	\$43,743
<i>*Cash and cash equivalents at end of year are comprised of the following:</i>			
Insurance and other	\$24,302	\$37,703	\$37,977
Utilities and energy	280	1,178	343
Finance and financial products	957	5,448	5,423
	\$25,539	\$44,329	\$43,743

Derivatives

Derivative contracts of Berkshire's finance and financial products businesses, with limited exceptions, are not designated as hedges for financial reporting purposes. Changes in the fair value of such contracts that do not qualify as hedges are reported in the consolidated statements of earnings as derivative gains/losses. A summary of these contracts as of December 31, 2008 and 2007 follows (in millions).

	2008			2007		
	Assets	Liabilities	Notional Value	Assets	Liabilities	Notional Value
Equity index put options	\$—	\$10,022	\$37,134 ²	\$—	\$4,610	\$35,043
Credit default obligations:						
High-yield indexes	—	3,031	7,892	—	1,838	4,660
Individual corporate	—	105	3,900	—	—	—

	2008			2007		
	Assets	Liabilities	Notional Value	Assets	Liabilities	Notional Value
States/municipalities	—	958	18,364	—	—	—
Other	503	528		749	489	
Counterparty netting and funds held as collateral	(295)	(32)		(50)	(50)	
	<u>\$208</u>	<u>\$14,612</u>		<u>\$699</u>	<u>\$6,887</u>	

Sources: Berkshire Hathaway financial statements from its June 30, 2009, 10Q and 2008 10K.

Example:

SWS Group is a diversified financial services company. The firm's operating activities section is shown to highlight dividends received as an operating activity because SWS is a member bank of the Federal Home Loan Banking system and is required to own its stock.

Joint-venture dividends would be shown under investing activities. Entities that own investments in other firms may receive dividends, which are presented under operations. If dividends are from a foreign entity, the risk to payment should be assessed. There have been instances where foreign nations have put pressure on companies to pay out dividends, so such cash receipts may not be certain because they may reflect cash flows that impair the entity's future prospects. Exchange controls also may alter a U.S. firm's ability to collect dividends.

	2009	2008	2007
Cash flows from operating activities:			
Net income	\$23,631	\$31,932	\$37,609
Income from discontinued operations	—	(17)	(102)
Extraordinary gain	—	(1,061)	—
Adjustments to reconcile net income to net cash (used in) provided by operating activities:			
Depreciation and amortization	6,036	4,955	4,790
Amortization of premiums on loans purchased	(487)	(725)	(1,278)
Amortization of premiums municipal bonds	(6)	—	—
Provision for doubtful accounts and write-downs on REO properties	15,419	4,659	1,538
Deferred income tax (benefit) expense	(6,115)	1,471	632
Deferred compensation	330	1,812	3,139
Gain on sale of loans	(628)	(951)	(999)
Loss on sale of fixed assets	2	196	146

(Continued)

	2009	2008	2007
Loss (gain) on sale of real estate	1,346	(396)	(668)
Gain on sale of factored receivables	(260)	(666)	—
Loss on investment in marketable equity securities available for sale	4,971	—	—
Equity in losses (earnings) of unconsolidated ventures	1,375	(235)	861
Dividend received on investment in Federal Home Loan Bank stock	(79)	(179)	(163)
Windfall tax benefits	(67)	(218)	(225)
Net change in minority interest in consolidated subsidiaries	—	(50)	(234)
Cash flow from operating activities of discontinued operations	—	4	298
Change in operating assets and liabilities:			
Decrease (increase) in assets segregated for regulatory purposes	9,422	(3,310)	25,763
Net change in broker, dealer, and clearing organization accounts	16,410	8,923	(19,862)
Net change in client accounts	(1,776)	41,480	(8,245)
Net change in loans held for sale	97,165	(211,932)	(23,139)
Decrease (increase) in securities owned	23,543	(66,432)	39,383
(Increase) decrease in securities purchased under agreements to resell	(11,760)	32,624	21,150
Decrease (increase) in other assets	5,695	5,274	(7,383)
Increase (decrease) in drafts payable	7,800	(6,061)	(3,426)
Increase (decrease) in securities sold, not yet purchased	26,725	(36,959)	(33,439)
Increase (decrease) in other liabilities	7,997	(1,828)	780
Net cash provided by (used in) operating activities	226,689	(197,690)	36,9

Example:

A. Schulman, Inc., supplies plastic compounds and resins to consumer products, industrial, automotive, and packaging markets. The downturn in the markets forced the company to restructure its business, including employee layoffs, and to withdraw from its multiemployer pension plan. The costs of these actions were reflected in a restructuring charge in the income statement, with the noncash portion reversed under operating activities. We see in the operating activity section how management aggressively stepped up collection of accounts receivable and drew down inventories to provide cash. This would be adjusted when using power operating cash flow.

A. SCHULMAN, INC.			
CONSOLIDATED STATEMENTS OF CASH FLOWS			
(In Thousands)			
	Year Ended August 31,		
	2009	2008	2007
Provided from (used in) operating activities:			
Net income (loss)	\$(2,776)	\$18,049	\$22,069
Adjustments to reconcile net income (loss) to net cash provided from (used in) operating activities:			
Depreciation and amortization	23,632	27,721	25,802
Deferred tax provision	(2,974)	(2,597)	(1,865)
Pension and other deferred compensation	3,955	3,259	11,347
Postretirement benefit obligation	773	2,839	(2,837)
Net losses on asset sales	740	318	68
Minority interest in net income of subsidiaries	349	872	1,027
Restructuring charges, including accelerated depreciation of \$1,326, \$0, and \$1,071 in 2009, 2008, and 2007, respectively	10,011	6,817	2,669
Goodwill impairment	—	964	—
Asset impairment	12,925	11,699	—
Curtailment gains	(2,805)	(4,009)	—
Proceeds of insurance settlements	—	—	750
Changes in assets and liabilities:			
Accounts receivable	91,218	16,614	(29,088)
Inventories	78,756	54,682	37,942
Accounts payable	(17,856)	25,838	(3,018)
Restructuring payments	(6,684)	(6,384)	(974)
Income taxes	3,720	(5,247)	(2,006)
Accrued payrolls and other accrued liabilities	(1,582)	1,704	789
Changes in other assets and other long-term liabilities	(9,905)	2,646	2,222
Net cash provided from operating activities	181,497	155,785	64,897

CASH CONVERSION CYCLE

The cash conversion cycle is an important operating cash-flow credit metric because it measures the duration, in days, between a company purchasing goods for sale and the ultimate collection of cash for the product. It is an important indicator because entities that can reduce the cash conversion cycle resulting from more optimal and efficient supply management, production, accounting, and collection procedures are also able to increase their free cash flow.

The *cash conversion cycle* is more appropriately defined as days of inventory and trade receivables outstanding less days of trade payables outstanding. Increases in the cash conversion cycle indicate that additional cash is consumed in the sales and manufacturing process that requires additional working capital.

Industries that, by their nature, have long cash collection cycles, as in the manufacturing of products that take a long time to produce, will need to more carefully manage their cash requirements over the cycle because there can be a negative gap between receipt of payments and cash disbursements. Such companies normally require progress payments, but even with such interim cash inflows, it would not be unusual for profits and a positive investment return to be deferred until delivery. These retainage payments could be held up if the quality of the product is in dispute, leading to further cash-flow funding gaps that would need to be financed.

Startup projects and newer companies are often required to finance development of products that might take years to come to market, requiring large outlays for labor and materials. For these entities, the cash conversion cycle, as typically defined, is not appropriate. For such entities, the analyst would evaluate the required funding, including cash on hand, cash flow from operations, and outside financing.

For industrial companies that manufacture new-generation products with long lead times, such as Lockheed, the initial number of deliveries often results in poor cash flows. However, as they move up the production learning curve, their efficiency and cash flows are greatly improved.

Example:

Textron, Inc., during a February 2010 conference call, credited its being able to achieve an 80 percent cash conversion ratio in helping bring down its targeted debt ratio, improve its liquidity ratio, and push up a projected return to profit growth.

Example:

Waste Management, during its third-quarter 2009 quarterly conference call, attributed its step up in free cash flow to "a good conversion ratio and being tight on working capital and capex." The company had been converting 120 percent of net income into cash over the prior 3 years, according to its chief financial officer.

Example:

The Kellogg Company and its subsidiaries are engaged in the manufacture and marketing of ready-to-eat cereal and convenience foods. The cash conversion cycle, even for a strong cash-flow generator such as Kellogg, is an important credit and cash-flow metric, and its components

are essential to analyze for their impact on the final result. For instance, a lengthening of the collection period could mean that one (or more) of the company's customers is experiencing business difficulties or a problem with supply or delivery. Shortening of the cycle would allow the company to invest additional funds short term, thus earning cash.

Companies with a short conversion cycle (that more quickly turns sales into cash), such as Kellogg, see a closer matching between net income and operating cash flows, although specific results for any particular year may be significantly affected by the level of benefit plan contributions, working capital movements (operating assets and liabilities), and other factors.

KELLOGG COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS
(Millions)

	2007	2006	2005
Operating activities:			
Net earnings	\$1,103	\$1,004	\$980
Adjustments to reconcile net earnings to operating cash flows:			
Depreciation and amortization	372	353	392
Deferred income taxes	(69)	(44)	(59)
Other (a)	183	235	199
Pension and other postretirement benefit contributions	(96)	(99)	(397)
Changes in operating assets and liabilities	10	(39)	28
Net cash provided by operating activities	\$1,503	\$1,410	\$1,143

Calculating the Cash Conversion Cycle

Most companies do not calculate the cash conversion cycle for investors despite its importance. I have found that most companies that do discuss this metric tend to have greater focus on and run their business with all decisions based on its cash-flow impact.

One of the more interesting companies that does report the benchmark is Dell Computer, which, historically, has been so adept in its manufacturing process, along with excellent credit collection while extending payables, that it has a negative conversion cycle, indicating that it uses its suppliers' cash (not its own) to manufacture the products it sells. As explained in its 2009 10K:

We ended the fourth quarter of Fiscal 2009 with a negative cash conversion cycle of 25 days, which is a contraction of 11 days from the fourth quarter of Fiscal 2008. The contraction is due to a decrease in our accounts payable balance, which is primarily driven by a reduction in purchases related to declining unit volumes. A negative cash conversion

cycle combined with a slowdown in revenue growth could result in cash use in excess of cash generated. Generally, as our growth stabilizes, our cash generation from operating activities will improve.

In a footnote in its 10K addressing its cash conversion measurement, Dell explains:

Key Performance Metrics—Although our cash conversion cycle deteriorated from February 1, 2008, and February 2, 2007, our direct business model allows us to maintain an efficient cash conversion cycle, which compares favorably with that of others in our industry. As our growth stabilizes, more typical cash generation and a resulting cash conversion cycle are expected to resume.

The following table presents the components of our cash conversion cycle for the fourth quarter of each of the past three fiscal years:

	January 30, 2009	February 1, 2008	February 2, 2007
Days of sales outstanding ^a	35	36	31
Days of supply in inventory ^b	7	8	5
Days in accounts payable ^c	(67)	(80)	(78)
Cash conversion cycle	(25)	(36)	(42)

^aDays of sales outstanding ("DSO") calculates the average collection period of our receivables. DSO is based on the ending net trade receivables and the most recent quarterly revenue for each period. DSO also includes the effect of product costs related to customer shipments not yet recognized as revenue that are classified in other current assets. DSO is calculated by adding accounts receivable, net of allowance for doubtful accounts, and customer shipments in transit and dividing that sum by average net revenue per day for the current quarter (90 days). At January 30, 2009, February 1, 2008, and February 2, 2007, DSO and days of customer shipments not yet recognized were 31 and 4 days, 33 and 3 days, and 28 and 3 days, respectively.

^bDays of supply in inventory ("DSI") measures the average number of days from procurement to sale of our product. DSI is based on ending inventory and most recent quarterly cost of sales for each period. DSI is calculated by dividing inventory by average cost of goods sold per day for the current quarter (90 days).

^cDays in accounts payable ("DPO") calculates the average number of days our payables remain outstanding before payment. DPO is based on ending accounts payable and most recent quarterly cost of sales for each period. DPO is calculated by dividing accounts payable by average cost of goods sold per day for the current quarter (90 days).

Our cash conversion cycle contracted by eleven days at January 30, 2009, from February 1, 2008, driven by a thirteen day decrease in DPO offset by a one day decrease in DSO and a one day decrease in DSI. The decrease in DPO from February 1, 2008, is attributable to procurement throughput declines as a result of declining demand, reduction in inventory levels, and a decrease in non-production supplier payables as we continue to control our operating expense spending and the timing of purchases

from and payments to suppliers during the fourth quarter of Fiscal 2009 as compared to the fourth quarter of Fiscal 2008. The decrease in DSO from February 1, 2008, is attributable to the timing of revenue due to seasonal impact, partially offset by a shift to customers with longer payment terms.

Our cash conversion cycle contracted by six days at February 1, 2008 compared to February 2, 2007. This deterioration was driven by a five day increase in DSO largely attributed to timing of payments from customers, a continued shift in sales mix from domestic to international, and an increased presence in the retail channel. In addition, DSI increased by three days, which was primarily due to strategic materials purchases. The DSO and DSI declines were offset by a two-day increase in DPO largely attributed to an increase in the amount of strategic material purchases in inventory at the end of Fiscal 2008 and the number of suppliers with extended payment terms as compared to Fiscal 2007.

We defer the cost of revenue associated with customer shipments not yet recognized as revenue until they are delivered. These deferred costs are included in our reported DSO because we believe it presents a more accurate presentation of our DSO and cash conversion cycle. These deferred costs are recorded in other current assets in our Consolidated Statements of Financial Position and totaled \$556 million, \$519 million, and \$424 million at January 30, 2009, February 1, 2008, and February 2, 2007, respectively.

Source: Dell Computer 2009 10K.

Example:

A simple technique for a close approximation of the cash conversion cycle is based on the formula:

Days of supply in inventory + days of sales outstanding – days in accounts payable

Looking back at Kellogg we see¹³ that

$$\begin{aligned} \text{Days of supply in inventory} &= \frac{\text{days in year}}{\text{cost of goods sold / average inventory}} \\ &= \frac{365}{7,455 / \text{average inventory}} \end{aligned}$$

¹³ All data are in thousands except where noted. Also, for seasonal concerns, the firm may wish to weight the daily average toward those seasonal periods when most of its collections are received.

To calculate average inventory, we used the average of the year-end inventory for the past 2 fiscal years. A closer approximation would be the average of the four quarters, whereas the reporting entity would have the precise daily average inventory. That is why this formula results in an approximation. For year-end 2009 and 2008, reported inventory was \$897 million and \$924 million, or \$910.5 million average. So days in inventory for Kellogg are approximately

$$\frac{365}{(7,455/910.5)} = \frac{365}{8.187} = 44.57 \text{ days}$$

$$\begin{aligned} \text{Days of sales outstanding} &= \frac{\text{days in year}}{\text{sales} / \text{average accounts receivable}} \\ &= \frac{365}{12,822 / \text{average accounts receivable}} \end{aligned}$$

Again, a more precise reading would result from an average of the entity's four fiscal quarters and even more so with the daily data in possession of the entity itself because its cash management software would have such information. We see from Kellogg's last two fiscal years that its accounts receivable at the end of the fiscal year was \$1,143 and \$1,001, or a \$1,072 average, so that

$$\text{DSO} = \frac{365}{(12,822/1,072)} = \frac{365}{11.96} = 30.51 \text{ days}$$

$$\begin{aligned} \text{Days in accounts payable} &= \frac{\text{days in year}}{\text{cost of goods sold} / \text{accounts payable}} \\ &= \frac{365}{(7,455/1,145)} = \frac{365}{6.57} = 55.57 \text{ days} \end{aligned}$$

Kellogg had its cash tied up an average of 44.57 days in inventory and waited 30.51 days to be paid. During the period, the company took, on average, 55.57 days to pay its trade payables.

Summary of Kellogg's Cash Conversion Cycle

$$\begin{aligned} \text{Cash conversion cycle} &= \text{days of supply in inventory} + \text{days receivable} - \text{days to pay} \\ &= 45.57 + 30.51 - 55.57 \\ &= 20.51 \text{ days} \end{aligned}$$

In its 2008 10K, Kellogg reported that its cash conversion cycle was actually 22 days. The reason the estimation was fairly close was that Kellogg's working-capital items and cost of sales remained in a relatively tight range. If quarterly data were used, the difference would have been less than 1 day compared with my

estimation. In any event, Kellogg reports in its 10K that it was able to reduce its cash conversion cycle during the year owing to a decrease in days of inventory outstanding. This is additional cash the entity has on its balance sheet that can be invested and represents an improvement to operating cash flows and metrics based on operating cash flow.

SUPPLEMENTAL INFORMATION

SFAS No. 95 required firms to disclose additional information about their important economic events during the period beyond the direct cash-flow implications of these events. For example, when a firm engages in a transaction that is, in effect, a financing or an investing event, but where the entire consideration is not in cash, the firm should report the transaction in a separate schedule, usually at the bottom of the statement of cash flows. Supplemental disclosure is necessary because financing and investing events are significant economic events, they affect the long-run viability of the firm, and they should be disclosed to investors and creditors regardless of whether they involve cash alone or combine cash and other considerations. For this reason, it is important to scrutinize the supplemental information. Contained here can be very significant information, such as the consideration for acquisitions for which a majority of the payment was not in cash. Some would argue that such events really should be contained under financing activities. The important considerations are the cash effects, peer comparability, and any changes to the capital structure.

The FASB also required firms that report net operating cash flows using the indirect approach to report the tax payments and interest payments during the period. Prior to SFAS 95, an analyst could only guess at the cash taxes paid—and more often than not, it remained a guess.

The biggest shortcoming under SFAS 95 is the failure under the statement to reveal the actual cash tax rate as implied in the firm's federal tax return. Cash taxes paid, as given under supplemental information, represented a big step forward, but in order to see how the effective tax rate really compared with the statutory rate, the analyst would need to calculate an implied rate. As I show in the section "Income Taxes" below, companies are required to state how the effective tax rate differs from the statutory rate. In my cost-of-capital model I estimate the cash tax rate by dividing cash taxes paid by pretax income, plus, where applicable, certain permanent timing differences, such as amortization, where that represents a permanent difference.

Let us examine several disclosures of these supplementary items. Because an entity is required to reveal significant items as a supplemental activity, reporting practices vary.

Example:

Baldor Electric Company is a leading marketer, designer, and manufacturer of industrial electric motors, mechanical power transmission products, drives, and generators. In 2007, Baldor purchased Reliance Electric for cash and stock. At the time of closing, Baldor estimated the stock value at \$50.9 million, which, because it was a partial noncash event, was listed as supplemental information. We do see the cash part of the transaction (which excludes the cash held by Reliance at closing) under investing activities, with the borrowing to finance the cash-payment portion of the deal under financing activities.

We also see, presumably to save cash needed as working capital, that Baldor contributed stock from treasury into its employee profit-sharing plan. Doing this artificially boosts cash flow from operations versus firms that contribute cash. Firms investing their own stock into profit-sharing or pension plans add additional risk to their employees because the employees are already dependent on the firm; their pension security should be diversified away from this.

Supplemental cash-flow disclosure revealed important information regarding this business acquisition, including its financing.

	2009	2008	2007
Investing activities:			
Purchases of property, plant, and equipment	(42,877)	(39,490)	(26,649)
Proceeds from sale of property, plant, and equipment	69	3,493	45
Marketable securities purchased	—	—	(470)
Proceeds from sale of marketable securities	—	23,034	10,286
Acquisitions net of cash acquired	(41,285)	(1,779,837)	—
Divestitures	—	49,886	—
Proceeds from sale of equity investment	1,373	—	—
Net proceeds from real estate transaction	23,310	—	—
Net cash used in investing activities	(59,410)	(1,742,914)	(16,788)
Financing activities:			
Proceeds from long-term obligations	137,535	1,550,000	30,000
Principal payments of long-term obligations	(177,960)	(283,000)	(28,000)
Proceeds from note payable	—	12,321	—
Debt issuance costs	—	(30,519)	—
Principal payments on note payable	(11,586)	—	—
Proceeds from common stock issued	—	379,857	—
Dividends paid	(31,392)	(31,184)	(21,891)
Common stock repurchased	—	—	(38,464)
Stock option exercises	11,133	11,397	13,995
Excess tax benefits on share-based payments	399	668	2,149
Net increase (decrease) in bank overdrafts	7,500	(4,624)	4,624
Net cash (used in) provided by financing activities	(64,371)	1,604,916	(37,587)
Net (decrease) increase in cash and cash equivalents	(24,659)	25,020	1,263
Beginning cash and cash equivalents	37,757	12,737	11,474
Ending cash and cash equivalents	\$13,098	\$37,757	\$12,73

Supplemental Cash Flow Information**Noncash Items**

- Additional paid-in capital resulting from shares traded for option exercises amounted to \$1,411 in 2008, \$3,040 in 2007, and \$2,763 in 2006.
- Common stock valued at \$50,932 was issued January 31, 2007, in conjunction with the acquisition of Reliance Electric (see Note B).
- Treasury shares issued in March 2008 in the amount of \$3,284 to fund 2007 accrued profit-sharing contribution.

Note B—Acquisitions

On January 31, 2007, Baldor completed the acquisition of all the equity of Reliance Electric ("Reliance") from Rockwell Automation, Inc., and certain of its affiliates ("Rockwell"). Reliance was a leading manufacturer of industrial electric motors and other mechanical power transmission products. The acquisition extended Baldor's product offerings, provided a manufacturing base in China for the Asian markets, increased the company's manufacturing capabilities and flexibility, strengthened the management team, and provided strong opportunities for synergies and cost savings. The purchase price was \$1.83 billion, consisting of \$1.78 billion in cash and 1.58 million shares of Baldor common stock valued at \$50.93 million, based on the average closing price per share of Baldor's common stock on the New York Stock Exchange for the 3 days preceding and the 3 days subsequent to November 6, 2006, the date of the definitive purchase agreement. The cash portion of the purchase price was funded with proceeds from the issuance of 10,294,118 shares of Baldor common stock at a price of \$34.00 per common share, proceeds from the issuance of \$550.0 million of 8.625 percent senior notes due 2017, and borrowings of \$1.00 billion under a new \$1.20 billion senior secured credit facility. In conjunction with an over-allotment option in the common stock offering, 1,430,882 additional common shares were issued at a price of \$34 per share. Proceeds from the over-allotment offering of approximately \$46.5 million were utilized to reduce borrowings under the senior secured credit facility. Reliance's results of operations are included in the consolidated financial statements beginning February 1, 2007.

Example:

Arch Chemicals, a biochemical concern, reports in its September 2009 10Q as supplemental cash flow information the final working capital adjustments of a business acquisition. Of the \$8.7 million in intangible assets, \$4.2 million represented trademarks, which are not subject to amortization, thus representing a permanent tax timing difference.

	(\$ in Millions)
Working capital (including cash):	\$11.7
Property, plant, and equipment, net	4.1
Intangible assets	8.7
Goodwill	4.6
Noncurrent assets and liabilities (including debt)	(8.0)
Investment a advances—affiliated companies at equity	(5.6)
Cash paid	\$15.5

Example:

American Home Food Products is engaged in the manufacturing and marketing of private-label and specialty food products. The company lacked liquidity to pay its cash dividends to common and preferred stockholders and so made the payments in kind by issuing additional shares. We also see that the company satisfied trade payables with equity as well. Since these stock contributions represent a noncash payment, they are included as supplemental cash-flow information. Also seen are the liabilities assumed that are related to an acquisition. I would reduce cash flow from operations by the \$137,036 and the \$530,000 to arrive at adjusted operating cash flow because these are expenses normally paid with cash.

Payments in kind (issuing shares in exchange for assets) are one example of a supplemental activity. Another example would be converting debt to equity and exchanges, for instance, exchanging noncash assets or liabilities for other noncash assets or liabilities.

SUPPLEMENTAL CASH FLOW INFORMATION

	2009	2008
Cash paid during the period for:		
Interest	\$—	\$—
Income taxes	—	—
Noncash financing activities:		
Preferred and common shares issued for services	\$—	137,036
Common shares issued for registration penalty	104,300	—
Preferred shares issued for dividend	680,246	449,850
Seller financing for the purchase of Artisanal	—	1,200,000
Payables paid with issuance of equity	—	530,000
Artisanal liabilities assumed	\$—	\$688,72

Source: American Home Food Products 2009 10K.

Example:

Tandy Leather Factory is a retailer and wholesale distributor of a broad line of leather and related products, including working tools, buckles, and adornments for belts, leather dyes and finishes, saddle and tack hardware, and do-it-yourself kits. The top of its supplemental schedule is quite typical. The company next shows equipment that was acquired under capital lease and property acquired with debt. The reason land and buildings acquired with long-term debt is shown as a non-cash activity is that the property was acquired without using cash. I would adjust this transaction to show the asset purchase and the borrowing as investment and financing activities. The property was acquired under a line of credit that was to be converted to a term loan at a later period. Since these are noncash-based investing activities, Tandy reports the transactions in its 2008 10K as supplemental cash-flow disclosures. While entering a capital lease is regarded as a supplemental activity, repayment of principal on capital leases would be reported as a financing activity.

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Interest paid during the period	\$332,107	\$122,209	\$—
Income tax paid during the period, net of (refunds)	878,110	1,830,688	2,282,113
Noncash investing activities:			
Equipment acquired under capital lease financing arrangements	\$803,713	—	—
Land and building acquired with long-term debt	—	\$4,050,000	

Example:

Illustrated next is the supplemental disclosure section for Schlumberger, Ltd., a large oil services company. Above its supplemental information from its 2008 10K, the company provides a separate line entry for cash flow from discontinued operations, allowing the analyst better comparability and forecasting of future cash flows.

The supplemental disclosure section reflects the currency translation effect of balance-sheet cash. Currency translation, a noncash activity, being a change in foreign currencies relative to the host currency (U.S. dollars), is also shown as part of other comprehensive income (loss) on the balance sheet and statement of shareholders' equity. These gains or losses also could include the effects of derivative contracts related to changes in currency movements. Foreign currency is sensitive to both exchange-rate and interest-rate risk. To the extent that a foreign currency relative to the U.S. dollar (host currency) changes, it would have an impact on the value on translation back to the host. As SFAS 95 states: "A statement of cash flows of an enterprise with foreign currency transactions or foreign operations shall report the reporting currency equivalent of foreign currency cash flows using the exchange rates in effect at the time of the cash flows." An appropriately weighted average exchange rate for the period may be used for translation if the result is substantially the same as if the rates at the dates of the cash flows were used.

Translation of foreign currency can affect working-capital analysis. To the extent that it reflects volatility in the exchange rate and not cash generated, such swings should be ignored, especially if the parent has not shown a desire to or for any reason cannot remit cash back to the United States. Other effects, such as a change in the value of a foreign entity that could be monetized, would enter the cost of capital model.

SUPPLEMENTARY INFORMATION

	Year Ended December 31 (In Millions)		
	2009	2008	2007
Cash flows from operating activities:			
Cash flow from discontinued operations—operating activities	(45)	63	—
Net increase (decrease) in cash before translation effect	54	(6)	28
Translation effect on cash	—	(2)	3
Cash, beginning of year	189	197	166
Cash, end of year	243	\$189	\$197

Example:

Thor Industries manufactures and sells a wide range of recreation vehicles and small and mid-sized buses in the United States and Canada. Capital expenditures that have not used cash (an accrued item shown in accounts payable) are reflected as a supplemental item. If a cash outlay was associated with the event, the transaction would be listed as an investing activity. You also can see the cancellation of restricted stock that had been issued previously. At the time of issuance, it also was recorded as a noncash event.

Noncash transactions:

Capital expenditures in accounts payable	\$53	\$543	\$203
Cancellation of restricted stock	\$—	\$—	\$35
Deferred taxes, net	\$—	\$562	\$—

Example:

Abercrombie and Fitch, the large clothing retailer, capitalizes construction work in progress, which appears in the property, plant, and equipment account on its balance sheet. This is a common practice for the utility and extractive industries, where the outflow of cash is also capitalized in the drilling process. For Abercrombie, when the accrual declined (a noncash item), it was reported as a supplemental activity.

Significant noncash investing activities:

Change in accrual for construction in progress	\$(27,913)	\$8,791	\$28,455
--	------------	---------	----------

Source: Abercrombie and Fitch 2009 10K.

Example:

Palatin Technologies, a biopharmaceutical company, recognized the value of tenant allowances (rent otherwise due) for leasehold improvements as supplemental cash flow because no cash was exchanged in return for occupancy. Palatin also paid for license fees (to other firms holding the patents) with stock. The firm sold \$37 million in stock and warrants the subsequent year, paying cash for the licensing fees.

Supplemental cash flow information:

Cash paid for interest	\$30,522	\$14,171	\$22,649
Assets acquired by capital lease	326,214	—	—
Tenant allowances recognized in deferred rent	—	210,924	—
Common stock issued for license fees	—	317,900	—

Source: Palatin Technologies 2006 10K.

Example:

Monsanto, a large provider of agricultural products, reports supplemental cash flow information as a footnote, and the company then redirected analysts to other footnotes. The most significant entry relates to Monsanto's restructuring involving various divisions, shown as its Note 5. Presumably, the restructuring will lead to greater increases in prospective cash flows, and the analyst should determine why the restructuring was undertaken. Monsanto booked a \$361 million restructuring expense on its P&L during 2009, which, since it was noncash, was reversed under operating activities. The company also realized a tax benefit from the book loss owing to the restructuring, for which the company showed a lower effective tax rate; however, as reported, actual tax payments rose, primarily resulting from foreign tax payments, as reported in the tax footnote.

Cash payments for interest and taxes during fiscal years 2009, 2008, and 2007 were as follows:

	Year Ended August 31, (In Millions)		
	2009	2008	2007
Interest	\$136	\$105	\$111
Taxes	657	596	482

During fiscal years 2009, 2008, and 2007, the company recorded the following noncash investing and financing transactions:

- During fiscal year 2009, the company recognized noncash transactions related to restructuring. See Note 5—Restructuring.
- In 2009, the company recognized noncash transactions related to a new capital lease. Long-term debt, short-term debt, and assets of \$18 million, \$2 million, and \$20 million, respectively, were recorded as a result of payment provisions under the lease agreement.
- During fiscal years 2009, 2008, and 2007, the company recognized noncash transactions related to restricted stock units and acquisitions. See Note 20—Stock-Based Compensation Plans—for further discussion of restricted stock units and Note 4—Business Combinations—for details of adjustments to goodwill.
- In fourth quarter 2009, 2008, and 2007, the board of directors declared a dividend payable in first quarter 2010, 2009, and 2008, respectively. As of August 31, 2009, 2008, and 2007, a dividend payable of \$145 million, \$132 million, and \$96 million, respectively, was recorded.
- In 2008, intangible assets in the amount of \$20 million and a liability in the amount of \$10 million were recorded as a result of payment provisions under a joint venture agreement. See Note 11—Investments and Equity Affiliates—for further discussion of the agreement.
- In 2009 and 2008, intangible assets of \$4 million and \$16 million, long-term investments of \$2 million and \$7 million, and liabilities of \$6 million and \$23 million, respectively, were recorded as a result of payment provisions under collaboration and license agreements. See Note 11—Investments and Equity Affiliates—for further discussion of the investments.
- In 2007, intangible assets and a liability in the amount of \$15 million were recorded as a result of minimum payment provisions under a license agreement. See Note 10—Goodwill and Other Intangible Assets—for further discussion of the agreement.

Note 5: Restructuring

Restructuring charges were recorded in the Statement of Consolidated Operations as follows:

	Year Ended Aug. 31, 2009 (In Millions)
Cost of goods sold ¹	\$(45)
Restructuring charges ¹	(361)
Loss from continuing operations before income taxes	(406)
Income tax benefit	116
Net loss	\$(290)

¹The \$45 million of restructuring charges recorded in cost of goods sold were split by segment as follows: \$1 million in Agricultural Productivity and \$44 million in Seeds and Genomics. The \$361 million of restructuring charges were split by segment as follows: \$113 million in Agricultural Productivity and \$248 million in Seeds and Genomics.

POWER OPERATING CASH FLOW

Cash flow from operations adjusted for balance-sheet items is referred to as *power operating cash flow* (power OCF) because it includes a normalized adjustment for inventory, accounts receivable, accounts payables, and other important working-capital items, thereby creating a less managed version of the FASB definition of GAAP-defined operating cash flows. For example, during business slowdowns, reported cash flow from operations typically exhibits strength, while reported earnings and power operating cash flows more accurately reflect the underlying weakness. During other periods, GAAP measured cash flow from operating activities may show the entity as not being a good cash generator, when in fact, that is not the case, as normalization or unusual activities are accounted for.

Power operating cash flow is a “normalized” cash flow if the company would have maintained these working-capital accounts at average levels (in proportion to sales) that the company experienced in the previous 5 years. Because working-capital items are normally subject to period volatility and are easily managed, power operating cash flow is often more useful and can result in a better assessment of comparability among companies—it is often a more powerful marker owing to the elimination of distortions that would relate to any management bias. It is thus a better indication of normalized period liquidity generation, including if used as a beginning value from which to estimate free cash flow instead of cash flow from operations. The actual free cash flow would require beginning with reported cash flow from operations because it would represent the actual distributable cash during the period. For this reason, I begin my estimation of free cash flow with cash flow from operations, not power OCF, although in my cost-of-capital model, power OCF is an important metric.

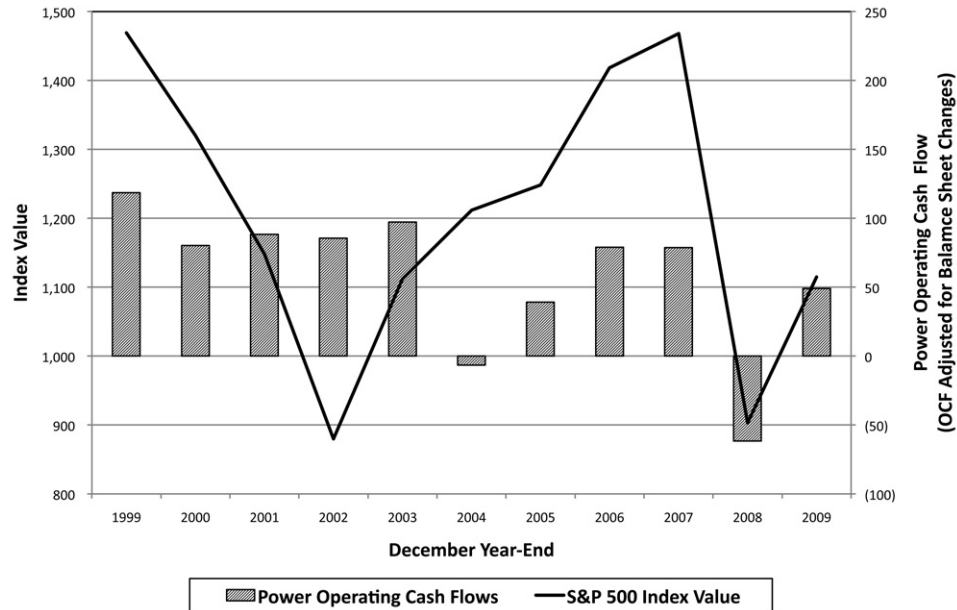
Aside from the working-capital items included in my definition of power OCF, it is also important to consider other significant company-specific current assets or liabilities that are subject to rapid management discretion and need to be normalized such that power OCF could provide a more accurate indication of and clearer visibility into the current financial picture, including where the near-term direction of the business lies. When an entity shows relative stability and similar growth of both cash flow from operations and power OCF, management typically is conducting business under a normal state of affairs, balance-sheet levels are in equilibrium relative to revenues, and cash collections are at acceptable levels. However, when there is a large deviation in a working-capital item or items, there is commonly some event that is associated with it or an expectation of a change in business conditions. The definition of what constitutes a large deviation would be decided by the analyst and could vary in time and magnitude. It is conceivable that a single quarter could be significant if the information relayed from the working-capital change is sufficiently large.

Sometimes the event causing a break between power OCF and OCF simply may be a desire for better asset utilization, with the intended effect of improving free cash flow. For this reason, I look at the 5-year average when normalizing balance-sheet ratios, assuming that there have been no major changes to the business composition; a deviation may be the result of a significant divestiture, acquisition, or change in the manufacturing process or expected level of business. Whatever the event, there is always a reason working-capital items have made a telling swing relative to reported operating cash flow, and they can provide an important clue as to current or impending changes in the risk profile. If there has been a significant change to the business, I would shorten the 5-year period or include that information from the combined entity.

As seen in Figure 3-4, there is a fairly consistent and smooth relationship between the Standard and Poor's (S&P) 500 Index and the average power OCF, with power OCFs topping out in 2003, several years ahead of the large bear market. The power OCFs in the figure are weighted using S&P divisors,¹⁴ identical to the index. Between 1999 and 2004, power OCF declined, with a large fall in 2000, preceding the 2001 recession, which began in March and lasted a brief 8 months. While power OCF fell in 2004 and stocks rallied, the increase in the S&P was 9 percent.

During 2007, power OCF declined, in contradiction to the S&P 500, which rose. For 2008, power OCF turned decidedly negative, consistent with the steep recession and in contradiction with reported operating cash flows (not shown) for the S&P 500 group of companies, which were positive by \$137 million, its

¹⁴ The companies in the figure are weighted using official S&P divisors, which is not the weighted average. For example, to calculate the power OCFs, I calculated the sum for all companies in the index and then divided by the S&P divisor for the index, which is not released publicly.

FIGURE 3-4**S&P 500 Composite Power Operating Cash Flows versus S&P 500 Index**

highest of the decade, because managers were extremely aggressive in their management of working capital. During 2009, power OCF rose, coming out of the recession, followed by a large rise in equity prices.

Example:

Starwood, one of world's largest hotel companies, significantly enhanced its operating cash flows through large tax benefits related to asset sales. When backing these benefits out, the result is a normalized view of the health of the operating companies that make up Starwood. Starwood's management, by taking advantage of tax benefits related to these sales, was able to provide a very large boost in operating cash flows, illustrating the importance of normalizing the balance sheet to gain a longer-term perspective. Figure 3-5 shows the smooth relationship between OCF(exclusive of the tax benefit) and market value for Starwood.

Security analysts who follow the hotel and lodging industry have, as a primary focus, RevPar, defined as revenues per available room. They believe that greater revenues per room will result in greater earnings and cash flows, bringing a higher stock price. However, this is not always the case. During business slowdowns, as was observed during the recession that began in 2007, many hotel executives lowered their room pricing, resulting in total revenues showing only minor declines, yet their stock prices had very meaningful falls owing to the drop in free cash flow.

Figure 3-5 shows for Starwood Hotels the stronger relationship between power OCF and market capitalization than with revenues, the primary driver of RevPar, which, for instance, fell by just 1.2 percent for Starwood for their fiscal year ending 2008, according to the company's 10K. On the other hand, power OCFs tumbled.

Except for 2008, the relationship is extremely strong, when power OCFs rose despite the fall in GAAP-reported cash flow from operating activities. During the first 6 months of 2009, however, Starwood stock rose by 24 percent, again following power OCF.

On a related note, Starwood has been reporting a very inconsistent tax rate, normally a negative indicator. We will discuss this in Chapter 6.

FIGURE 3-5

Starwood Power OCF after Adjustment for Tax Benefits of 2006–2008

