



# Go With the Flow

*Find Out How to Use the Cash-Flow Statement to Best Analyze Your Company's Most Vital Asset*

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**C**ASH FLOW IS PERHAPS the greatest concern to home medical equipment (HME) companies. Unfortunately, of the three primary financial statements generally prepared by accountants—the balance sheet, income statement and statement of cash flow—the cash-flow statement is the least understood and hence the most overlooked. However, with a basic understanding of this

statement, great insight can be gained into what is essentially the company's lifeblood—cash flow.

The cash-flow statement is vital because it captures, in one place, the cash-flow impact of the firm's operations and its investing and financing activities. The statement is accordingly broken down into three categories—cash flow from operations, cash flow from investing activities and cash flow from financing activities.

## Cash Flow From Operations

THIS PORTION OF THE STATEMENT represents the cash flow resulting from the company's primary function, which for our purposes is the sale and rental of HME products and services.

Positive cash flow from operations is generated when billings collected are greater than expenses disbursed. Operational cash flow can be negative as well, perhaps due to losses from operations. Negative cash flow can also result from exceedingly rapid yet profitable growth, in which expenses must be paid before receivables are collected.

Since this type of cash flow comes from the company's profits, it requires the greatest scrutiny. Unfortunately, the operations portion of the cash-flow statement can be confusing because, for firms using accru-

al-based accounting, it includes what seem to be unrelated entries for depreciation and changes in various working capital accounts (current assets and liabilities). The difficulty stems from the fact that, in preparing the statement, operating cash flow begins with accrual-based net income, which must then be adjusted to reflect non-cash entries, accrued but uncollected revenue, accrued but unpaid expenses, and other changes in working capital accounts.

<b>Net Income</b>	<b>\$50,000</b>
<b>Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:</b>	
Depreciation	\$10,000
Increase in Accounts Receivable	(\$40,000)
Increase in Accounts Payable	\$5,000
<hr style="border-top: 1px dashed black;"/>	
<b>Net Cash Provided by Operating Activities</b>	<b>\$25,000</b>

Consider the above example of a statement of cash flow. The company's net income of \$50,000 is net of the depreciation expense of \$10,000. Since de-

preciation is a non-cash expense (the company does not actually disburse funds for depreciation), the net income must be increased by \$10,000. Note that depreciation does not actually provide cash—it is simply a reconciling entry.

The next adjusting entry indicates that accounts receivable has increased by \$40,000. This increase

requires a like deduction to reflect the fact that accrual-based net income includes \$40,000 of revenue that was booked but not collected. Had accounts receivable decreased, the reconciling entry would be positive to reflect cash collected.

Following similar logic, a \$5,000 increase in accounts payable requires a \$5,000 addition to cash flow to reflect the fact that, although net income is reported after this expense, it has not yet been paid. Again, had accounts payable decreased, the reconciling entry would be negative to reflect cash disbursed.

The sum of net income, depreciation and the reconciliation of all working capital accounts represents the total cash generated by the company's operating activities.

#### **Cash Flow From Investing Activities**

THIS TYPE OF CASH FLOW generally reflects the acquisition of non-current assets. For HME companies, these assets might include rental equipment, vehicles, furniture and fixtures, leasehold improvements and buildings. As investments that provide benefits for many years, these expenses are not immediately reflected on the company's income statement. Rather, they are recognized over time through depreciation. However, because they do require cash, such acquisitions cause a reduction of cash flow.

#### **Cash Flow From Financing Activities**

THIS REPRESENTS THE CASH FLOW resulting from borrowings and equity—the company's primary sources of capital. Increases in debt or the sale of stock during the period, which are not reflected in operating net income, add to the company's cash flow. Repayment of debt or the payment of dividends, which are also not reflected in operating income, reduce cash flow. The aggregate of these different types of cash flow represents the net cash from financing activities.

The statement of cash flow combines cash from operations and investing and financing activities, the aggregate of which reconciles cash at the beginning of the period to cash at the end of the period. With this statement, HME companies can begin to understand why it is possible to be profitable and short of cash at the same time. Perhaps substantial revenue—and hence income—has not been collected, as evidenced by an increase in accounts receivable. Perhaps substantial cash has been used to pay down prior accounts payable, as evidenced by a decrease in

accounts payable. These events would generate a subsequent reduction in cash flow from operations.

Critical insight into where cash is coming from and where it is going can be gained from

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the cash-flow statement. As such, it is an extremely valuable tool that deserves close scrutiny. **HC**

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