

COMMENT

Cash flow may mask problems

There are countless ways to manipulate short-term flows

AL ROSEN

Cash is King is a cliché that shows up everywhere from analyst reports to fund management marketing materials. It is supposed to mean cash flows tell the truth even when net income is lying. Unfortunately, such beliefs can lead to serious financial mistakes and investment losses. In short, cash is trash.

The biggest problem is many investors believe the numbers they see on the cash flow statement have a different origin from those on the income statement. In fact, they are closer in substance than people realize. Cash from operations and free cash flow are derived directly from net income.

Most companies only make a few adjustments to get from net earnings to cash from operations. The problem is there are dozens of accounting accruals involved in calculating earnings. The lack of adjustments on the cash flow statement means many of those "non-cash" accruals are leaking through, and polluting the cash flow figures.

Take pension expenses as just one example of this problem. In order to calculate cash from operations, "non-cash" pension expense is added back to net income. In its place, one would expect to see a deduction for the "cash" cost of the pension plan during the year. Of course, a problem exists if the company has not made any cash contribution to the plan. In essence, the employee benefits provided by the pension plan appear to come free of charge to the company even though it is clearly benefiting from the existence of the plan.

Indeed, if the company is on a pension contribution holiday, it may not have made any cash contributions for several years. Therefore, anyone using the last five years of cash flow data as a measure of operating performance would be completely missing the fact that the pension plan is a longer-term expense for the company that should be recognized in its valuation.

Another serious problem with cash flows is many investors only focus on operating cash flows or free cash flows. For years, we have been showing our clients how cash from investing or financing sources can be easily shifted into cash from operations. Nevertheless, investors still favour looking at the 35%-40% of the cash flow statement

FREE CASH FLOW IS NOT A PANACEA FOR THE PROBLEMS OF NET INCOME

that comprises free cash flow. We liken that to basing a valuation on 35%-40% of the income statement. It doesn't make sense to only look as far down as gross margin on the income statement, so why only look as far as free cash flow on the cash flow statement?

Just a few of the ways to manipulate free cash flow include aggressive asset securitizations, turning bad receivables into investments, clever financings that funnel equity discounts into revenue, stock option repurchases, and overstating or understating the value of certain acquired assets. In short, management can easily manipulate free cash flow by blurring the lines between operating, investing, and financing cash flows.

On top of selective classification, companies can also easily employ selective timing. Simply sitting on bills longer improves free cash flow.

Likewise, companies can take a haircut on future margins in order to secure faster payment terms on their current receivables. There are countless ways for management to improve cash flows in the short term to the detriment of the company over the long term. Many managers have escalated such schemes with each passing quarter in the hopes a magical turnaround would mask the slow deterioration of the business. Unfortunately, these schemes almost always come crashing down.

Keep in mind that this is all done with cash flows, the supposed king of the financial statements.

In presenting these issues to our institutional clients over the past several years, the main question is always the same: What is a good measure of free cash flow that takes these tricks into consideration?

Unfortunately, there is no easy answer. You can make adjustments for long-term receivables, or stock option repurchases, but different companies will always have unique problems. We continue to discover them on a monthly basis. Unless investors are looking at the entire cash flow statement, companies will always find a way to fool with the figures you're not watching.

In addition, there will always be questions of how to treat working capital or capital expenditures in a growing company. The biggest problem surrounding not just income trusts, but all companies, is how to determine an appropriate level of maintenance capital expenditures.

There are no rules of thumb to help here. An understatement of maintenance capex can only be uncovered through a close familiarity of the company, and a regular review of all its public disclosures. There are no short cuts or quantitative screens that will catch the numerous cash flow manipulation techniques that exist.

Free cash flow is not a panacea for the problems of net income. In fact, looking at just 35%-40% of one page in the financial statements is a great way to lose money. So ignore the rumours, and repeat after me — the King is Dead.

Financial Post

■ Al Rosen is a forensic accountant at Accountability Research Corp., an independent equity research firm.