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## Cash flow myths

Al Rosen

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It's just too easy to mislead the average investor in Canada. Financial reports can be arcane and confusing even for professionals. Adding to the problem are regulators who don't care to clean up pervasive scams, much less make financial statements more usable for investors.

As part of an ongoing series, the focus in this issue is on the cash flow statement. We're starting where most financial-statement tutorials end, because most textbooks are wrong in praising the cash flow statement as the answer to investors' needs. Many investors ignore income statement tricks because they think they can rely on cash flows. This is a dangerous myth.

Essentially, the cash flow statement has three sections: financing (cash increases or decreases in debt or equity); investing (cash increases or decreases in longer-term assets); and operations (buying and selling products or services, including the impacts on receivables, payables, inventory and other current accounts).

Often to their own detriment, investors will overfocus on operating cash flows or so-called free cash flows, and ignore important changes in the financing and investing sections of the cash flow statement. Companies come in all shapes and sizes, and can't be compared blindly using a partial valuation metric like free cash flow. Free cash flow figures can be very misleading unless proper adjustments are made.

This is where investors get tripped up. We tell our institutional money-managing clients that all cash flow mistakes result from the arbitrary timing or classification of management actions or inactions. The cash flow statement represents cash amounts. But, they are unevenly categorized, and worst of all, smoothed and shifted from period to period.


Investors tend to forget that accounting cash flows are not "real." Actual cash flows into a company are first recorded using an accrual (non-cash) income basis, and then translated back into a quasi-cash basis on the cash flow statement. This back-and-forth dance creates what I like to call leakage.

Leakage can be caused by pension plans, income taxes, stock options, corporate acquisitions, minority interests, asset securitizations and a host of other factors. You can't steer clear of investing in companies with these characteristics (unless you want to stuff your money in your mattress), so you have to know how to make proper cash flow adjustments.

I can't explain all of the examples of mistimed or misclassified cash flows here, so I'll focus on two examples of where cash flows are mistimed: one in the short term, and one over the longer term.

An example of a short-term timing adjustment is when debt is reclassified from being a long-term liability to being a current liability. This happens

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when long-term debt is coming due within the next year. When current liabilities increase, cash from operations increases. The effect is similar to when a company stretches out the time it takes to pay its suppliers. The short-term "increase" in cash is simply a result of not paying out cash that is owed by the company. In other words, the effect is temporary and can overstate the cash that the company appeared to receive from operations during the year.

An example of a longer-term timing adjustment is pension expenses. Companies will add back non-cash pension expenses to their net income, boosting cash from operations. However, the actual cash flow to cover those expenses might be delayed for several years under loose pension funding requirements. The result is that cash from operations is overstated, and investors could end up overvaluing the company. Longer-term timing adjustments tend to be more insidious, and thus, more dangerous for investors to overlook.

As complicated as the foregoing seems, investors must learn these common shenanigans. Company management might not even be trying to mislead investors, and you could still end up making a serious investment mistake. That being said, just think what's possible when unscrupulous executives try to actively manipulate their financial statements.

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