Lecture 9

- Cash related decision-making
    - Every decision has multiple implications on employee satisfaction, sales, costs, etc.
- Cash Flow Statement
    - Summarises movement of cash over period; also a measure of financial performance; how company obtains and utilises cash; shows liquidity and solvency of entity
    - Interrelated with Income Statement and Balance Sheet
        - Balance Sheet at start and end is a stock, where Income Statement and Cash Flow Statement represent flows that helps us to get from BS start to BS end
- Significant Non-Cash Activities
    - Not picked up by cash or profit calculations (CFS or IS)
    - Ie. issue of share to purchase assets (give shares to someone to buy assets)
    - Exchange of PPE (swap)
    - These items are disclosed in the notes of the Cash Flow Statement
- Definitions
    - Cash and cash equivalents: highly liquid investments, cash on hand
    - <u>Operating activities:</u> come from principal revenue-producing activities (CA, CL, Revenue and Expenses)
    - <u>Investing activities:</u> Related to sale or purchase of NCAs
    - <u>Financing activities:</u> Result in changes in contributed equity & borrowings (NCL, Cont Equity)
        - Interest received and dividend received- operating or investing activity (interest is revenue so increased profit- operating, but can be investing since we receiving interest since we made investment to lend money)
        - Interest paid and dividend paid- operating or financing activity (interest is expense and dividend is distribution of profit so operating; pay dividend if you issue shares or interest since borrowings so financing)
        - If you issue shares, financing, if you buy shares, investing
- Purpose of Cash Flow Statement
    - Assess ability to generate cash flows
    - Meet financial commitments
- Difference between Net Operating Cash Flow and Net Operating Profit
    - Some receipts are revenue but not all of them are (ie. receipts from debtors)
        - Not all revenue are receipts (ie. credit sales)
    - Some payments are expenses but not all are expenses (ie. creditors payment)
        - Not all expenses are cash payments (accrued expenses)
    - As a result, profitable firms can fail on account of poor cash management, causing liquidity crisis
    - Divergence effect

        - Champagne glass effect that at some point the two will diverge, sustain high levels of growth, whilst not collecting appropriate amount of cash, leading to liquidity crisis
    - Quality of Income Ratio
        - =Cash Flow from Operating Activities/Net Income (proportion of income collected cash, higher the better, ie. for all income, receive cash)
- Cash vs Profit
    - Argued that profit is subject to estimates and bias whereas cash measurement is quite objective (cash flow focuses on liquidity)
    - Accrual accounting method is a more useful performance measure
    - Both are thus useful in different ways
- Preparation of Cash Flow Statement
    - Method
        - Direct method
            - List key line items, major classes of cash receipts
        - Indirect method
            - Calculate profit and then reconcile with operating cash flow
    - Sources of information
        - Balance Sheet, Income Statement & Additional information
    - Steps
        - 1. Determine net change in cash (BS)
        - 2. Determine net cash from operating activities
            - Cash receipts from customers
                - Sales figure, accounts receivable, reconstruct T account for A.R
            - Cash paid to suppliers
                - Reconstruct inventory account (calculate amount of inventory purchased)
                - Put in A/P account to determine cash paid to suppliers
            - Cash payment for income tax (must be operating)
                - Construct T account to calculate cash payments for I/T
        - 3. Net cash from investing activities
            - NCAs can be funded by debt (no cash flow)
        - 4. Net cash from financing activities
            - Inflows: issue shares, nots
            - Outflows: dividends, repay notes
- Assessing liquidity and solvency
    - Liquidity
        - Current cash debt coverage= Net cash from operating activities/Avg. total liabilities
            - The ability of the entity to meet its immediate obligations
    - Solvency
        - Cash debt coverage= Net cash from operating activities/Avg. total liabilities
            - The ability of an entity to survive over the long term
- Analysis implications

    - Income statements measures rev/exp but not timings of cash flows
        - Cash flow from operations is measure of financial performance, not profitability

Lecture 10

- Debt v Equity decision-making
    - Consider
        - Return on equity
        - Existing Capital structure & how will change
        - Liquidity and solvency risk (future debt payments)
        - Potential changes in interest rates
            - Inverse relationship with ROE in debt option
        - Change in ownership structure
        - Profit realisation and its sustainability
    - Debt advantages
        - No dilutionary effect, tax savings since interest is tax-deductible & higher return on equity (equity does not increase)
    - Analysis
        - Explanation for why you'd rule out debt option (ie. lower ROE) is that you are paying too much interest given the level of profit you generate
    - Capital raising example 1
        - Looking to raise equity, so offer discounted shares to existing shareholders. This increases total no. shares issued, diluting EPS and pressure of future dividend payments (spread amongst bigger base)
        - Pressured to boost amount of capital as opposed to equity which makes for a stronger balance sheet
    - Capital raising example 2
        - Target debt reduction by maximising operating cash flow (no interest payments)
        - More capital reduces uncertainty
    - Adjustments for Capital Structure
      Adjustments we need to take into account when analysing capital structure
        - Off balance-sheet financing- possible to increase debt without disclosing (ie. through another company)
        - Contingent Liability- possible increase in debt (until very likely won't be "debt")
        - Convertible Debt/Notes- possible increase in equity (at some point debt will change to equity, at discretion of noteholder)
        - Preference shares- treated similar to debt since fixed dividend is like loan repayment
    - Exam question
        - Fill table + what other factors need to be considered
- Du Pont Analysis
    - Level 1
        - ROA (PM * TN), ROE