SOURCES AND USES OF CASH AND IMPROVING CASH FLOW

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LEARNING OBJECTIVES

At the end of the session, students should be able to:

- Identify the classification of cash flows
- Prepare a statement of cash flows

CASH

BALANCE SHEETS

- ✓ Increase in property, plant, and equipment during the year
- ✗ How the additions were financed or paid for

INCOME STATEMENT

- ✓ Net income
- ✗ Amount of cash generated by operating activities

STATEMENT OF CASH FLOWS

- Reports a firm's **major cash inflows and outflows** for a period
- Reports the cash **receipts**, cash **payments**, and **net change** in cash resulting from *operating, investing, and financing activities* during a period

STATEMENT OF CASH FLOWS

Enables assessment of:

1. The entity's ability to generate future cash flows
2. The entity's ability to pay dividends and meet obligations
3. The reasons for the difference between net income and net cash provided (used) by operating activities
4. The cash investing and financing transactions during the period

STATEMENT OF CASH FLOWS

Reports cash flows by three types of activities:

CASH FLOWS FROM OPERATING ACTIVITIES	From transactions that affect **net income**
CASH FLOWS FROM INVESTING ACTIVITIES	From transactions that affect the **investments in noncurrent assets**
CASH FLOWS FROM FINANCING ACTIVITIES	From transactions that affect the **equity and debt of the business**

TYPES OF CASH INFLOWS AND OUTFLOWS

Operating activities—Income statement items

Cash inflows:

From sale of goods or services.

From interest received and dividends received.

Cash outflows:

To suppliers for inventory.

To employees for wages.

To government for taxes.

To lenders for interest.

To others for expenses.

Investing activities—Changes in investments and long-term assets

Cash inflows:

From sale of property, plant, and equipment.

From sale of investments in debt or equity securities of other entities.

From collection of principal on loans to other entities.

Cash outflows:

To purchase property, plant, and equipment.

To purchase investments in debt or equity securities of other entities.

To make loans to other entities.

Financing activities—Changes in long-term liabilities and stockholders' equity

Cash inflows:

From sale of common stock.

From issuance of debt (bonds and notes).

Cash outflows:

To stockholders as dividends.

To redeem long-term debt or reacquire capital stock (treasury stock).

CLASSIFY EACH TRANSACTION BY TYPE OF CASH FLOW ACTIVITY

During its first week, Duffy & Stevenson Company had these transactions.

1. Issued 100,000 shares of $5 par value common stock for $800,000 cash.
2. Borrowed $200,000 from Castle Bank, signing a 5-year note bearing 8% interest.
3. Purchased two semi-trailer trucks for $170,000 cash.
4. Paid employees $12,000 for salaries and wages.
5. Collected $20,000 cash for services performed.

PREPARING STATEMENT OF CASH FLOWS

COMPANY NAME
Statement of Cash Flows
For the Period Covered

Cash flows from operating activities		
(List of individual items)	XX	
Net cash provided (used) by operating activities		XXX
Cash flows from investing activities		
(List of individual inflows and outflows)	XX	
Net cash provided (used) by investing activities		XXX
Cash flows from financing activities		
(List of individual inflows and outflows)	XX	
Net cash provided (used) by financing activities		XXX
Net increase (decrease) in cash		XXX
Cash at beginning of period		XXX
Cash at end of period		XXX
Noncash investing and financing activities		
(List of individual noncash transactions)		XXX

PREPARING STATEMENT OF CASH FLOWS

Information comes from 3 sources:

1. <u>Comparative balance sheets</u>
   - indicates the amount of the **changes in assets, liabilities, and stockholders' equities** from the beginning to the end of the period
2. <u>Current income statement</u>
   - helps determine the **amount of net cash** provided or used by operating activities during the period
3. <u>Additional information</u>
   - includes transaction data that are needed to determine **how cash was provided or used** during the period

STEP 1: OPERATING ACTIVITIES

- Determine the net cash provided/used by operating activities
- Adjust net income to convert certain items to the cash basis

Net Income	+/−	Adjustments	=	Net Cash Provided/ Used by Operating Activities
		• **Add back noncash expenses**, such as depreciation expense and amortization expense. • **Deduct gains and add losses** that resulted from investing and financing activities. • **Analyze changes** to noncash current asset and current liability accounts.		

DEPRECIATION EXPENSE

- Depreciation is similar to any other expense in that it reduces net income.
- It differs in that it does not involve a current cash outflow. That is why it must be **added back to net income** to arrive at net cash provided by operating activities.

LOSS ON DISPOSAL OF EQUIPMENT

- Cash received from the sale (disposal) of plant assets is reported in the *investing* activities section.
- Because of this, companies **eliminate from net income** all gains and losses related to the disposal of plant assets, to arrive at net cash provided by operating activities

CHANGES IN NONCASH CURRENT ASSETS

- **Deduct** from net income **increases** in current asset accounts, and add to net income decreases in current asset accounts, to arrive at net cash provided by operating activities.

CHANGES IN CURRENT LIABILITIES

- **Add** to net income **increases** in current liability accounts and <u>deduct</u> from net income <u>decreases</u> in current liability accounts, to arrive at net cash provided by operating activities.

ADJUSTMENTS REQUIRED TO CONVERT NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES

		Adjustments Required to Convert Net Income to Net Cash Provided by Operating Activities
Noncash Charges	Depreciation expense	Add
	Amortization expense	Add
Gains and Losses	Loss on disposal of plant assets	Add
	Gain on disposal of plant assets	Deduct
Changes in Current Assets and Current Liabilities	Increase in current asset account	Deduct
	Decrease in current asset account	Add
	Increase in current liability account	Add
	Decrease in current liability account	Deduct

STEP 2: INVESTING & FINANCING ACTIVITIES

- Analyze changes in **noncurrent asset and liability** accounts and record as investing and financing activities, or as **noncash** investing and financing activities

✓ Land	✓ Bonds payable
✓ Buildings	✓ Common stock
✓ Equipment	✓ Retained earnings

INVESTING ACTIVITIES

Land

- If land was purchased by directly exchanging bonds for land, there is no effect on cash
- Noncash investing activity that merits disclosure

Building

- Purchase of building = cash outflow

Equipment

- Purchase of equipment = cash outflow
- Sale of equipment = cash inflow

FINANCING ACTIVITIES

Bonds payable

- If bonds payable increased to acquire land, there is no effect on cash
- Noncash transaction that merits disclosure

Common stock

- Issuance of new shares of stock = cash inflow

Retained earnings

- Payment of dividends = cash outflow

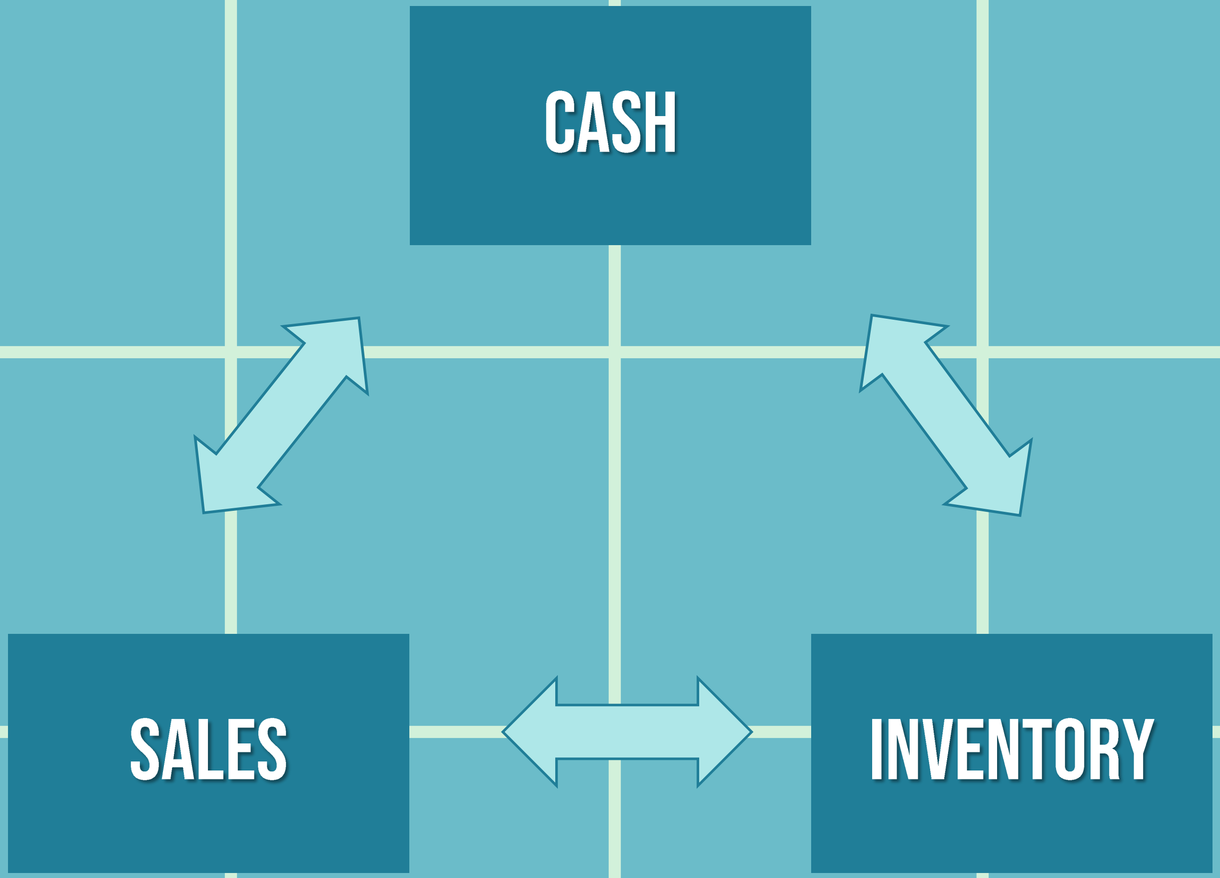
STEP 3: NET CHANGE IN CASH

- Compare the **net change in cash** on the statement of cash flows with the change in the **cash account** reported on the balance sheet to make sure the amounts agree

IMPROVING CASH FLOW

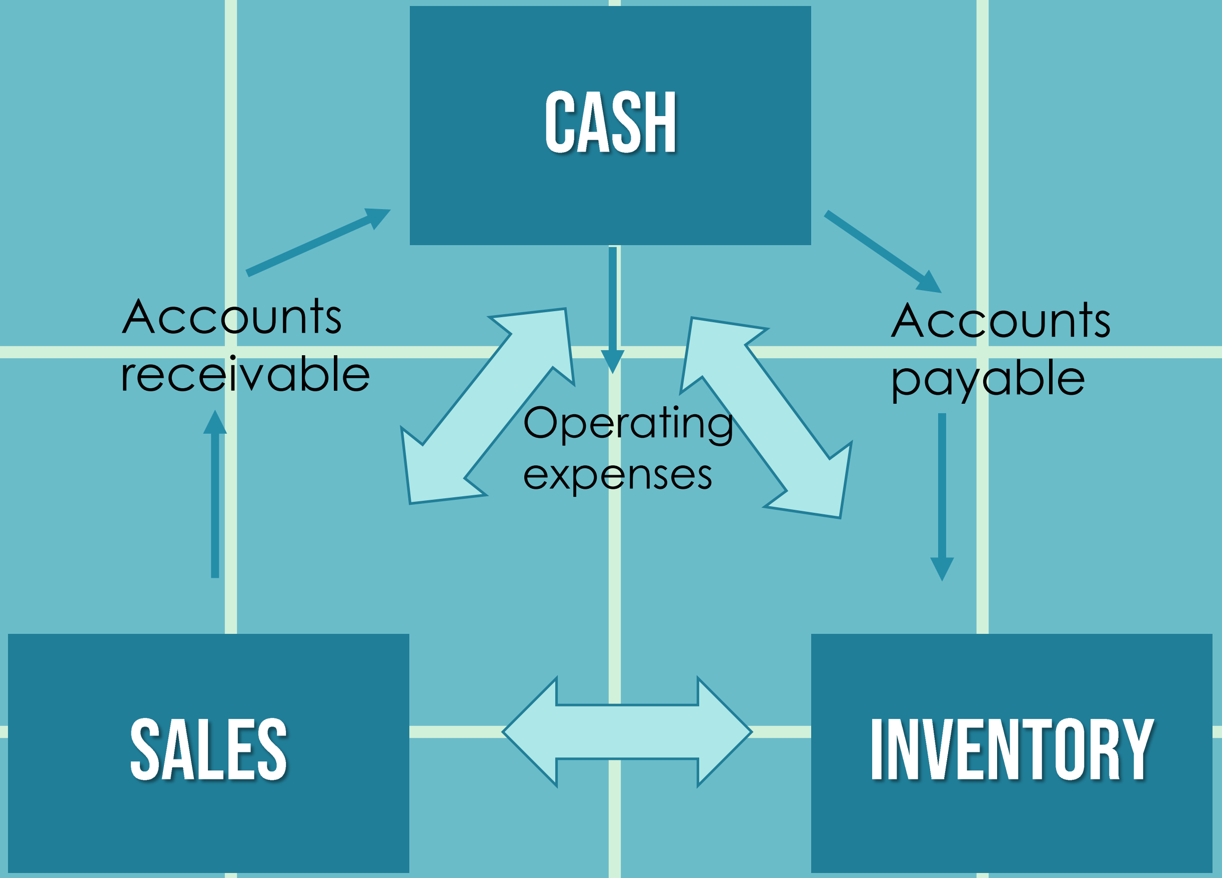
CASH FLOW CYCLE

- Cash flows out to buy inventories
- Inventories are sold
- Goods sold brings cash into business



REVENUE CYCLE

- Pharmacy buys on credit
- Pharmacies can sell on credit
- Cash flows out of the pharmacy to cover for salaries & utilities



IMPROVING CASH FLOW

- Decreasing the amount of cash invested in the Pharmacy
- Slowing the amount of rate of cash flowing out of the Pharmacy
- Increasing the amount of rate of cash flowing in

WAYS TO IMPROVE CASH FLOW

1. Properly controlling inventory
2. Maintaining gross margin
3. Properly controlling accounts receivable
4. Timing of purchases and payments
5. Minimizing operating expenses

INVENTORY CONTROL

Inventory Size

- Cutting inventory (decrease inventory size) means freeing some of the money invested.

Inventory Quality

- Invest on salable merchandise

Shrinkage (lost through theft or breakage)

- High shrinkage → lost merchandise

Monitoring inventory

- ↓ inventory turnover ratio, pharmacy may need to check the quality/size of inventory

MAINTAINING GROSS MARGIN

$$Gross\ Margin = Pharmacy\ Selling\ Price\ - Price\ of\ Merchandise\ Bought$$

Gross margin: portion of sales that pharmacies have to cover operating expenses & profits

Emphasize high-margin products

- Identify which products are most profitable for the pharmacy based on its market

Selection of Third Party Contracts

- Carefully select third party contracts that your pharmacy will enter into
  - They usually pay less than cash-paying patients
  - Reimbursement rates may vary

MAINTAINING GROSS MARGIN

- Carefully compare and reconcile third party claims for the pharmacy's reimbursements
- Increase your price when manufacturer's price increase
- Make sure that payers are billed for all medications dispensed
- Decrease product cost
- Monitor and control gross margin of each line of products

INVESTING IDLE CASH

- Effects of investing:
  - Excess cash (idle) would earn interest
  - This improves both cash flow and net profit
- Selecting an investment:
  - Consider RISK, RETURN & LIQUIDITY
  - Gov't bonds, money market accounts: ↓risk, liquid
  - Bank savings: risk free, liquid, ↓return
  - Time deposits: less liquid
  - Stocks: ↑risk but ↑return
  - Money market accounts, treasury bills bonds, bank commercial papers: Acceptable & reasonable return

ACCOUNTS RECEIVABLE MANAGEMENT

Effects of credit program to cash flow:

- Pharmacy must invest a substantial amount of cash in the program (long-term investment) which is an opportunity cost
- Slows the rate of cash flow
- Incurs number of cost
- Most credit experience bad debt

MINIMIZING INVESTMENTS IN ACCOUNTS RECEIVABLE

To minimize opportunity cost and bad debts:

- Carefully screen credit applicants (as well as 3rd party payers)
- Send out bills promptly & regularly
- Add finance charge to overdue accounts
- Follow-up on overdue accounts
- If it does not work: revoke credit, turn to a collection agency or take it to court

MONITORING ACCOUNTS RECEIVABLE

- AR collection period: average length of time it takes the pharmacy to collect for purchases made on credit by its customers
- Monitoring = weekly or monthly

TIMING OF PURCHASES & PAYMENTS

- Improves cash flow because if you pay soon enough, you can receive cash discounts
- **Accounts payable ratio**: measures how quickly the pharmacy pays its suppliers for purchases made on credit.
  - Use this ratio to monitor the pharmacy's performance at proper timing of purchase/payments

DECREASING EXPENSES

Cut on major expenses such as:

- Rent
- Pharmacy salaries
- Technician salaries
- Computer expenses
- Delivery expenses