Cashflow Reporting - Back to Basics

Why Many Businesses Are Out of Control

By Ray Soper

Timely cashflow information could save many businesses from trouble—but too many managers and accountants fail to see the importance of some simple controls.

At least one in three of Australia’s small business failures might have been averted if management had known how to prepare and use simple cashflow forecasts and controls. Fortunately, some progress is now being made towards the introduction of cashflow reporting in Australia. The spectacular corporate crashes in the past few years have forced regulators to recognize this as an urgent need.

While the main impetus for the introduction of cashflow reporting comes from outraged investors and the regulators concerned about their interests, there are other reasons for welcoming the change. Many analysts regard it as a primary tool in understanding the real financial position of a company.

The Australian Accounting Standards Board will soon issue a new approved accounting standard which will require companies to disclose cashflow from operations along with a reconciliation to pre-tax operating profit. This standard, which could apply to June-reporting companies from as early as June 1991, is an interim measure pending the development of a comprehensive financial reporting standard on disclosure of cashflow information. An exposure draft is expected in the first half of this year. The AASB initiatives parallel similar standards in the US, the UK, New Zealand and elsewhere.

While clearly an important initiative in the improvement of the quality of accounting information, the introduction of cashflow reporting will also help to correct the fundamental problem facing many of Australia’s businesses, both large and small. That is, managers are not managing day-to-day cashflows. Their companies are out of control.

The fact is that many managers do not understand their companies’ internal cashflows—and often they get little help from their accountants. The demands of the authorities and investors for accurate historical accounts overwhelm requests for internal cashflow reports. Accountants become preoccupied with depreciation, accruals, tax issues and other matters relevant to historical accounts, and give no priority to cashflow analysis. Worse, many accountants simply do not know how to prepare these simple reports.

Here are some illustrations of the importance of cashflow analysis for small business:

- The manageress of a successful tile importing and retailing company could not understand the detailed computerized results prepared by her accountant. The business operated with long ordering lead-times, requiring careful management of orders, stocks and cashflow. The manageress felt out of control and blamed her own lack of management education for the problems of the business. Only when an experienced Ray Soper, a member of the Securities Institute, is a director of Resource Finance Corporation Ltd.
Managers who do understand the need for detailed cashflow control often find it difficult to persuade their accountants to give them what they need.

Few corporate accountants seem to understand basic cashflow control systems properly. They often have difficulty when dealing with the flaws inherent in forecasts; in contrast, most accountants feel comfortable with historical records. Many accountants appear to think that cashflow is defined as “profit, add back depreciation” rather than cash receipts less payments (cheques).

Little attention is given to cashflow management systems in management and accountancy training programs. Few investors, corporate managers, accountants, corporate regulators, bureaucrats or governments have ever had the experience of running a small business; many simply do not understand the vital importance of controlling day-to-day cashflows.

Clearly there is a need to look at the conflicting demands of running a company and providing accurate historical reports to investors and the regulatory authorities. One of the clear benefits of the move towards cashflow reporting is that it will force companies to deal with cashflow issues.

But much more needs to be done to educate managers and accountants to improve day-to-day control of their businesses. Managers must learn how to forecast and control anticipated receipts and payments; accountants must learn how to prepare these reports and resolve to give them priority.

The basic cashflow control tool is a monthly forecast of expected receipts and payments, in various categories, against which actual receipts and payments are reported. There will usually be no need for more than three or four receipt items or about ten payment items for any business unit. The cashflow report should match the monthly bank statements, apart from the minor timing differences that arise, for

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example, between the writing and presentation of a cheque. Some managers run these spreadsheets on a rolling 12-month basis; others prefer to work in accordance with business years. One of the most important benefits of this simple cashflow tool is that it gives an accurate indication of the company’s overdraft. A conflict will usually arise between the requirements of this cashflow tool and those of historical accounts. This conflict simply has to be dealt with. One way to maintain the cashflow spreadsheet manually, separate from the accounting system. Ideally, both needs can be satisfied from the accounts system, but experience shows that this is easier said than done.

Armed with a cashflow forecast, the manager has the means to manage his business. He can reschedule his creditors or negotiate longer payment terms for major purchases. Most important, he will have a ready tool to keep the bank manager informed about how the business is going, and be in a stronger position to negotiate an accommodation in the event of a cashflow shortage.

Some will protest that accounts systems already cater for managers’ needs for information. While this is true in many cases, the state of corporate crashes and the problems of small business demonstrate that all is not well in this area of fundamental importance.

Several areas of cashflow reporting need specific comment.

Funds flow statements

Users of financial reports agree that the funds flow statements provided in annual reports, which are supposed to shed light on how the company has financed its obligations, are often confusing. Companies are loath to disclose more than the absolute minimum about their operating cashflows, usually for competitive reasons. The funds flow statements, which tend to be based on changes in key balance-sheet items rather than revenue and expense streams, generally succeed in revealing very little.

Ernst & Young recently released an “ideal” set of accounts for a hypothetical company. These accounts included a source and application of funds statement which showed the proceeds of a rights issue as a negative item. This may be meaningful to

an accountant but it challenges the average user of financial statements—the shareholder and the financial analyst. It probably confuses the company’s managers as well.

The table gives an illustration of what an ideal funds flow statement should look like:

<table>
<thead>
<tr>
<th>Cash Inflows</th>
<th>Cash outflows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>Operating expenses</td>
</tr>
<tr>
<td>Interest income</td>
<td>Interest payments</td>
</tr>
<tr>
<td>Rental income</td>
<td>Total operating payments</td>
</tr>
<tr>
<td></td>
<td>Tax payments</td>
</tr>
<tr>
<td><strong>Total operating receipts</strong></td>
<td>Asset purchases</td>
</tr>
<tr>
<td>Asset sales</td>
<td>Capital expenditure</td>
</tr>
<tr>
<td>New borrowings</td>
<td>Loan repayments</td>
</tr>
<tr>
<td>Equity raisings</td>
<td>Dividends</td>
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<tr>
<td></td>
<td><strong>Total cash inflows</strong></td>
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<td></td>
<td><strong>Total cash outflows</strong></td>
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Junior mining and exploration companies are required to produce a quarterly report of “working capital”. These reports have become notorious for their shortcomings. The problems include:

- Usually only a “net working capital” figure is published. There is no requirement to separate cash and near-cash assets from investments. Some companies hold substantial investments as current assets, which seriously distorts this figure.
- There is no requirement to report the company’s debt position. This figure can change dramatically through the course of the year and is surely relevant.
- Similarly, there is no requirement for the company to present a statement of forward gold positions.
- Working capital reports have often proved to be inaccurate. There are a number of examples where the published annual accounts bear little relation to earlier working capital reports.

The Australian Stock Exchange is endeavouring to ensure the timeliness of quarterly and working capital reports. However, the quality and reliability of those reports must be improved if investors are to be attracted to this end of the market. The authorities are currently under some pressure to extend the requirement for quarterly reports from exploration companies to all companies. They should also consider requiring all companies to provide quarterly working capital reports. Introduction of these measures would certainly lead to a more informed and therefore more efficient equity market.