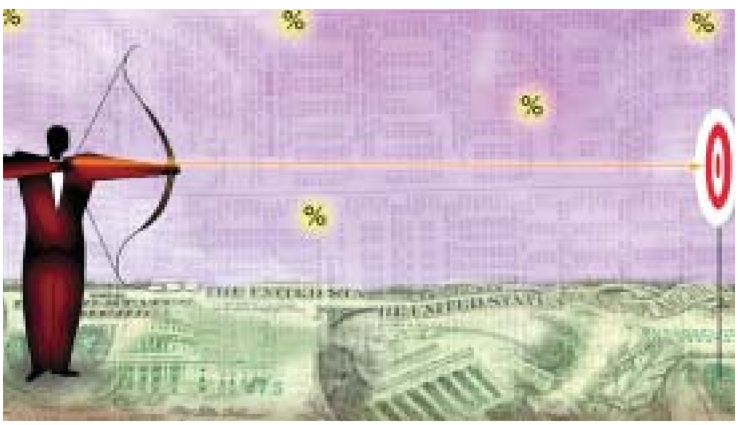
Strategic Decisions and Cash Flow

By Mark L. Frigo and Ron Graziano

The foundation of Return Driven Strategy (see the February 2002 column) is superior corporate performance measurement and valuation built with the solid concept of cash flow analysis. The challenge for management is to understand the true nature of cash flow information and its component of valuation as well as the myriad strategic decisions that lead to valuation. In this column, we take a look at the Statement of Cash Flows to help managers and executives from being misled when using cash flow analysis in strategic decisions.

We are recovering from one of the biggest stock market declines and experiencing one of the most aggressive periods of government reforms (Sarbanes-Oxley) in American history. Accordingly, the investment community and Corporate America are making a return to performance and valuation analysis based on cash flows. In the post-dot-com bubble, we have witnessed the process to measure financial performance evolve from “growth at any cost” to a renewed focus on, first, EPS (earnings per share), then EBITDA (earnings before interest, taxes, depreciation, and amortization), and now cash flows.



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The Statement of Cash Flows as required by U.S. generally accepted accounting principles is a source of information for financial performance and valuation, but many challenges and potential problems exist with it.

What Does It Really Tell Us?

As we all now more fully appreciate, the application of GAAP—whether creatively, deceptively, or sometimes even by mere chance—can misrepresent the real performance within financial statements, including the Statement of Cash Flows. This point couldn’t have been better illustrated than in a recent research report released by Credit Suisse First Boston, “When Cash Is Not Cash—and Why,” written by Joel Litman. Litman’s three-paragraph synopsis is directly on point:

- “The Statement of Cash Flows, often regarded as one of the most important pages in the Annual Report, can be viewed as one of the most flawed and misleading of the financial statements…"

- "For example, cash flow from operations, as reported in the financial statements, does not at all reflect the true cash generated by the operations of the business. Issues include the incorrect classification of such items as rental expense, research and development, and pension expenses. Most notoriously, changes in working capital are incorrectly considered changes in operating cash flow, instead of as investing and disinvesting activities, which is the true economic nature of the cash flow."
- "Trend analysis and valuation models that use the reported operational cash flow number can create serious mistakes in judgment, as reported cash flows from operations are materially, and inconsistently, distorted from year-to-year."

In fact, there are a number of areas where the Statement of Cash Flows can present misleading performance indicators. Examples include:

- *Securitized Receivables:* It's common for companies with retail exposure to set up joint-venture credit arms that reside off the balance sheet—i.e., special purpose entities (SPEs)—to account for securitized sales of product. As such, the associated receivables and liabilities that are traditionally part of the operating working capital of the business aren't represented on the Statement of Cash Flows from operations. Despite all the proposed changes and fallout from the Enron situation, use of SPEs for companies with retail exposure (especially those that sell durable consumer goods) is common.
- *Stock Options:* Public companies receive a tax deduction for the difference between the exercise price and market price on the date of exercise for nonqualified options. The tax savings can be a material nonrecurring boost to operating cash flows.

Management Applications

Strategic decisions including budgeting, planning, discounted cash flow (DCF) analysis, performance measurement, and valuation can be impacted by the quality of the cash flow information used in making the decisions.

Cash Flow Trend Analysis. Management should monitor trends in true operating cash flows so companies can determine actual cash-generating ability or finer points such as cyclicality.

Measuring the Nature of Earnings. Cash flows from operations as reported in the Statement of Cash Flows is often used as a yardstick against net income or other calculations as a benchmark of the quality of earnings. Sometimes earnings quality is calculated, but this number can be so awash with problems in consistency from year to year that its usefulness is questionable.

So if the cash flow statement has credibility issues, what's next?

Our objective is to remind the groups responsible for analyzing and communicating corporate performance:

- There are inherent flaws in GAAP-based statements, including the Statement of Cash Flows, and
- There is no silver bullet when it comes to measuring financial performance.

Now more than ever, the challenge to Corporate America is to identify the real issues that impact financial performance and lead to the creation of long-term shareholder returns. Specifically, companies must stop following the trends of the investment community and blindly tying the evaluation and communication of financial performance to GAAP-based statements. Each company must identify the issues unique to its investor positioning, strategy, and business model to enable investors to make real decisions based on performance and valuation.

Most important, the shortcomings of GAAP that are specific to a company's business model must be identified first. This is otherwise known as "quality of earnings" today. But this concept must extend to all financial statements and GAAP line items, including the Statement of Cash Flows.

There is no better example of this process than Warren Buffett, CEO of Berkshire Hathaway. Few people have more investor credibility. So how does Warren Buffet report and enable investors to gauge his company's real "quality of performance"? Here's an excerpt from the Berkshire 2002 Annual Report, subtitled: "The Economics of Property/Casualty Insurance."

"Our core business—though we have others of great importance—is insurance. To understand Berkshire, therefore, it is necessary that you *understand* how to evaluate an insurance company. The key determinants are…"

Mr. Buffet then dedicates a substantial amount of space within his annual letter defining the financial (and nonfinancial) metrics unique to his business—content that is critical to measuring the business yet isn't found in the GAAP statements.

Moving Forward

Return Driven Strategy is a framework for helping companies plan the activities and major initiatives that will drive long-term maximum shareholder wealth creation. Its foundation is strategic valuation and performance measurement. Companies that adhere to this process must first define a strategy to create value and then identify the appropriate benchmarks to measure progress. Forecasts on cash flow from operations can be a great place to start to measure returns.

Yet performance and valuations based on these cash flow streams can be incredibly difficult and inherently flawed because of the problems with the GAAP calculations unless companies take care to understand how to measure real cash flow returns more accurately. This could cause enormous problems with internal measurement of strategy and external assessments of valuation. If a corporation is operating under the tenets of Return Driven Strategy, financial managers will be forced to reevaluate the entire GAAP-based measurement process. This type of process is the only true way to determine if growth in GAAP-based reports like the Statement of Cash Flows is transcending to real financial performance and the commitment to create long-term shareholder value. ■

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