

Show Investors The Cash Flow

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In the 1996 film Jerry Maguire, football player Rod Tidwell (played by Cuba Gooding Jr.) exhorts his agent to negotiate a fat new contract by shouting, "Show me the money!"

With that now-famous phrase, the fictional Tidwell showed why he makes his living by scoring touchdowns, rather than by picking stocks. For if he had been a professional money manager, he surely would have yelled, "Show me the cash flow!"

The cash flow statement ought to be one of the most useful tools to any investor. Managers can use all kinds of tricks to dress up net income: boosting revenue with asset sales, deferring expenses, or hiding costs in large restructuring charges.

But in theory, at least, they can't fake cash flow. "With cash, there's not really too much you can do about it," says Dan Thornton, an accounting professor at Queen's University and a member of the national Accounting Standards Board. "You've either got it or you don't."

The cash flow statement should help clarify how a company made its money. Do the earnings per-share look good because the company's factories were humming, or because it sold off a division?

But too often, the cash flow statement adds little insight to a company's core operations. Take, as an example, Hudson's Bay Co. The Bay's business is pretty simple.

The Bay buys clothes, housewares and other products, puts them in its stores and sells them, hopefully for a profit.

When you look at the cash flow statement in the Bay's 2000 annual report, you find references to pensions, amortization and "net change in operating working capital." But you can't find the simple things, like how much cash the Bay received from shoppers or how much it paid its suppliers.

In the case of a retailer like the Bay, this is less of a problem, because the time between when it receives the goods and when it sells them is short.

But companies with longer sales cycles -- such as airplane manufacturers or engineering companies that work on large projects -- have more leeway in how they record revenue and expenses on the income statement. In other words, they're ripe for manipulation.

To understand these companies, cash flow is crucial.

An ugly example: Livent Inc., the now-defunct live theatre company. It reported sham profits in 1995 and 1996, based partly on an accounting decision to expense millions of dollars in costs over years, rather than right away.

"Livent was never cash-flow positive in any single quarter that it was a public company," notes Richard Rooney, president of Burgundy Asset Management Ltd. "It was usually massively cash-flow negative, because they were deferring huge costs."

But rather than clearly showing investors that it was paying out millions of dollars in pre-production expenses for its shows, Livent's confusing cash flow statement helped obfuscate the money trail -- making it harder for investors to foresee its collapse in 1998.

There is a solution -- one Mr. Rooney, who sits on the Accounting Standards Board, has been pushing for years. It's called the direct-method cash flow statement.

Few North American companies use it; one of them is Azcar Technologies Inc., a tiny TSE-listed technology company. Here's how its third-quarter cash flow statement reads:

- Cash receipts from customers: \$6.3-million.
- Cash paid to suppliers and employees: \$7.3-million.
- Net purchases of short-term investments: - \$389,000.
- Interest received: \$149,000.
- Income taxes paid: \$11,000.
- Total cash used in operations: \$479,000.

"It actually reflects the way the cash has arrived in the company and has been spent by the company," says Mr. Rooney. "I think it constitutes good disclosure."

He's convinced that clearer cash flow statements would have allowed investors to spot the rot in Livent and others much earlier. "Frankly, I would have loved to have seen a direct cash flow statement on Enron."

Prof. Thornton thinks the direct method is not a cure-all. "A sophisticated analyst shouldn't need it," says Prof. Thornton. But individual investors would benefit if all companies reported their numbers this way, he says.

So why don't more companies follow Azcar's example? "It gives material information, so managements don't want to use it," says Mr. Rooney, who wants to make the direct method mandatory.

"Something like this is comprehensible, easy to understand and I think it would be harder to fudge --
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though where there's a will, there's a way."