How to Master Analyzing the Cash Flow Statement

oldschoolvalue.com/blog/valuation-methods/analysing-financial-statements-and-aerogrow/

Jae Jun

In this post, I'll be going over a few basic ideas of what to look for in financial statements, not how to read them, for the beginner investor wanting to research or keep up to date with their companies. AeroGrow (AERO) will serve as a very nice example with plenty of warnings signs.

The purpose of this post is to help you understand the company's health and let you decide whether it is worth the extra effort to take the next step and plug in numbers for ratios and other metrics.

FYI, I exited my position in AeroGrow with a huge 60% loss even though I had the opportunity to lock in a 20% gain. I made many mistakes on this one (let's just conclude I didn't even read the statements properly) and you will see why I had no other choice than to sell once I woke up. Hopefully, you won't make the same mistake as me.

Financial Statements Basics

There are 3 parts to a financial statement. The Income Statement, Balance Sheet and the Statement of Cash Flows. Online sites usually show them in the mentioned order, but I always start with the Cash Flow statement and work backwards. Usually, a majority of the companies don't make it past the statement of cash flows.

I will assume you understand the basic definitions of words such as liabilities, assets, depreciation, amortization etc. If not, the following pages should bring you up to speed.

Intro to Cash and the Statement of Cash Flows

The Statement of Cash Flows details all cash inflow and outflows and boils it down to how much cash the company has generated in a given period. Income statement and balance sheets include the future incoming and outgoing cash recorded as credit.

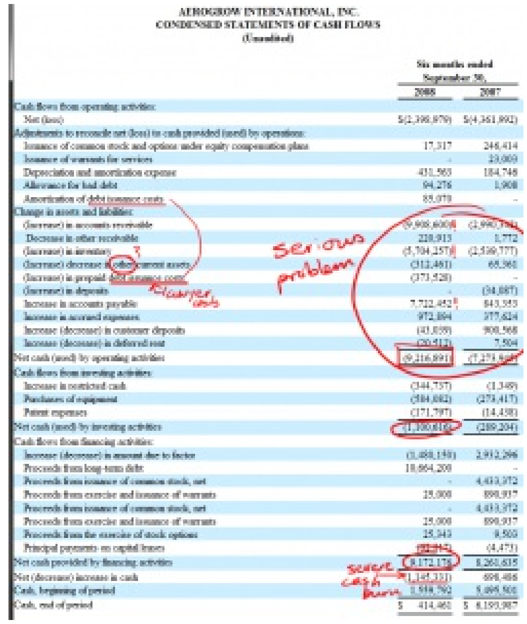
Cash is king and is the blood of a business – it has to flow evenly. Holding plenty of cash is never a bad thing but there are exceptions to this as well. On the other hand, too much outflow in one area is the equivalent of getting shot and seeing blood pour out from the hole. The basic and key idea is that cash is what a company needs to be healthy and generate earnings.

Cash flow is calculated by adding and subtracting certain items to the net income. These adjustments must be made because non-cash items may be included into the net income even though it does not represent any cash in the bank.

e.g. You sell an item with a condition that the buyer can use it for 30 days, and if they like it, they pay for it. Otherwise they return it during the 30 day period without paying anything. In this case, accounts receivables will go up which makes it seem like the assets have increased, but in cash terms, you did not receive a single cent. Thus the importance of seeing how this number is stated in the statements.

The AeroGrow Statement of Cash Flows

Accounts Receivable



AEROGROW INTERNATIONAL, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six months ended September 30, 2008	Six months ended September 30, 2007
Cash flows from operating activities:		
Net (loss)	$(2,398,979)	$(4,361,892)
Adjustments to reconcile net (loss) to cash provided (used) by operations:		
Issuance of common stock and options under equity compensation plans	17,317	248,414
Issuance of warrants for services	-	23,009
Depreciation and amortization expense	431,563	184,748
Allowance for bad debt	94,278	1,908
Amortization of debt issuance costs	85,079	-
Change in assets and liabilities:		
(Increase) in accounts receivable	(9,908,600)	(2,990,[illegible])
Decrease in other receivable	228,913	1,772
(Increase) in inventory	(5,704,257)	(2,539,777)
(Increase) decrease in other current assets	(312,461)	65,361
(Increase) in prepaid debt issuance costs	(373,528)	-
(Increase) in deposits	-	(34,087)
Increase in accounts payable	7,722,452	843,353
Increase in accrued expenses	972,894	377,624
Increase (decrease) in customer deposits	(43,059)	908,568
Increase (decrease) in deferred rent	(20,512)	7,504
Net cash (used) by operating activities	(9,216,891)	(7,273,[illegible])
Cash flows from investing activities:		
Increase in restricted cash	(344,737)	(1,349)
Purchases of equipment	(584,082)	(273,417)
Patent expenses	(171,797)	(14,438)
Net cash (used) by investing activities	(1,100,616)	(289,204)
Cash flows from financing activities:		
Increase (decrease) in amount due to factor	(1,488,159)	2,912,296
Proceeds from long-term debt	10,864,200	-
Proceeds from issuance of common stock, net	-	4,433,372
Proceeds from exercise and issuance of warrants	25,000	899,937
Proceeds from issuance of common stock, net	-	4,433,372
Proceeds from exercise and issuance of warrants	25,000	899,937
Proceeds from the exercise of stock options	25,343	9,503
Principal payments on capital leases	[illegible]	(4,473)
Net cash provided by financing activities	9,172,178	8,260,635
Net (decrease) increase in cash	(1,145,331)	698,486
Cash, beginning of period	1,559,792	5,495,501
Cash, end of period	$ 414,461	$ 6,193,987

If accounts receivable decreases from the previous years (you have to compare by going back a few years), this means that more cash has entered the company from customers paying off their credit accounts. If accounts receivable increases, this means that the company has sold more products that money received.

Enjoy what you're reading? Get Access to More

Get more tips and investing strategies in your inbox. I'll send you 9 FREE Investing Spreadsheets as a welcome bonus.

In AeroGrow's latest filing 10-Q filing (see above), we see that the cash related to accounts receivable decreased by $9.9 million compared to a decrease of $3 million a year ago. In other words, AERO sold $9.9 million worth of goods without being paid, compared to $3 million the prior year. They are both bad numbers, but the latest increase is a whopping 330%!

This is a huge warning sign that management is desperately, in a maniacal way, trying to get their products onto any available shelf. Far too aggressive.

Inventory

Same for inventory, which they burned $5.7 million on. Rather than managing it, they've multiplied it like cockroaches. They currently have $8.5 million in finished goods which I assume is supposed to meet the demand they were expecting, except they have announced an expected slow down.

It would have been better to keep it as raw materials and streamline assembly processes in order to meet demand. Raw materials could be sold at commodity prices if it came down to it, but finished goods collecting dust will only fetch 50% at best in a fire sale.

Good indicator that management is unrealistic with performance and does not perform proper market research.

(If raw materials increase but finished goods decrease, it means the company has a problem with efficiency, processes and ultimately meeting demand.)

Accounts Payable

The third big warning sign is accounts payable. Since this is a positive number, the cash hasn't left yet, so it's been added back to net income because it is stated as a liability in the Balance Sheet.

This means that AERO has delayed the payment but will have to pay this huge amount in another period. An increase of $7.7 million in payables will surely require the company to look for further credit or dilute shareholders in order to pay it down.

Cash From Operations

For a company to be healthy, the cash from operating activities should be positive, but the quality of the cash is just as important.

The net income at the top of the Cash Flow Statement should preferably be a high positive number and the adjustment differences should not be huge. If this is the case, the majority of cash from net income should drop to the Cash from Operations line.

We see AeroGrow went from a net income of $(2.4 million) to Cash Used in Operations of $(9.2 million) in 6 months. This is $2 million more than the previous year and considering the size of the company, this is a first degree burn.

You can also see the company spending to purchase new equipment and receiving $9 million from financing with over $10 million in debt from $0 one year ago. Not the quality we want to see. Unsuspecting investors may only see the Cash at Beginning of Period of $1.6 million and Cash at End of Period of $0.4 million and think they used up $1.2 million. But we can see the true number is $9.2 million.

Not to mention a $8 million market cap with $10 million in debt and more coming.. you do the math.

Conclusion

The latest news from AERO touts its first every profitable quarter masked behind a mess of cash outflows. We've just seen why it's more important to view cash than earnings.

I don't mean to pick on AeroGrow, and the company will hate me for writing this, but before getting into the details of ROE, ROA, margins, solvency, turnover etc, taking a quick glance at the statements will reveal the company for what it is and save you from deep trouble.