Case Study on Cash Flow

So far, as we have applied cash flow statements and models to Dry Supply, there have not been significant changes in cash flow beyond the cash profits generated by the income statement. In fact, the company has not shown significant changes in sales levels, while the balance sheet has been fairly steady in relation to sales. Profits have been consistent and growing modestly. The result is an overall cash flow situation where cash profits are the main driver, since there have not been significant cash flow demands from balance sheet changes.

In many lending situations, a business banker will encounter a much more dynamic set of financial statements, including high levels of sales growth, or changes in efficiency that amplify changes in accounts receivable, inventory and accounts payable. Such factors have led to a common saying in banking that "cash profits or EBITDA are not cash flow." We studied earnings before interest, depreciation, taxes, depreciation and amortization (EDITDA) as part of the debt coverage ratios. The danger in using cash profits or EBITDA in debt coverage ratios is the assumption that this portion of cash flow can be directed or funneled exclusively to the debt service needs of the business.

As an example, let's explore Dry Supply if it had experienced a sharp, 15 percent increase in sales for 2017 over 2016. The new level of net sales would be Rs.1,078,000 with profits of about Rs.27,000 if we assume the same net profit margin of 2.5 percent. To support the sales growth, assume that Dry Supply had to increase inventory levels by 25 percent, and the higher level of accounts receivable generated by the sales slowed down its collection efforts such that accounts receivable grew by 20 percent. Support from vendors kept pace with sales, with accounts payable growing by 20 percent. As a result, these accounts will become Rs.90,000; Rs.136,000 and Rs.55,000; respectively. Finally, we will assume the same changes to other assets and liabilities as originally shown for 2017.

Now prepare a statement of cash flow from operating activities and answer the following questions.

1. **Compared to the original cash flow of Dry Supply for 2017, has there been increase or decrease in the Cash from operation? What change has occurred in cash inflow and out flow due to the change in the dynamics of inventory, accounts receivables and account payables? Is the result of any concern? What would be the impact of this change on fixed asset investment and repayment capacity of the borrower?**