# Brew & Balance Sheets: A Friendly Dive into Financial Failure Forecasting

On a bright sunny morning, Vikas Ballal was sitting in a café, drinking his third cup of coffee, while waiting for his friend, Rakesh Arora. Vikas was in town, and both friends decided to meet for brunch.

While waiting for his friend, Vikas found a copy of the Wall Street Journal on the coffee table and a news headline caught his eye: "**Bankrupt Indian Companies Are Clogging the Economy—but Now the Clock Is Ticking."[1].** Vikas was a name to reckon in the fashion industry and owned a prestigious fashion house in the country. Finance has never been his area of interest, and he had entrusted the role of managing finances to his wife, a chartered accountant. However, this piece of news caught his interest, and he continued to read the article. He was so engrossed in reading that he failed to notice that Rakesh had arrived. Rakesh was a Chartered Accountant within his firm.

Rakesh: Such a pleasant surprise seeing you read The Wall Street Journal, Buddy!!! Is it the influence of your finance manager??

Vikas: I am so sorry, I did not notice you came in. I was reading this article on Bankrupt Indian companies clogging the economy. Its intriguing…Rakesh, I have a simple query. What is this bankruptcy, and can't this be predicted?

Rakesh: Well, this is something you should know.

Corporate bankruptcy is a potential threat to every organization and has a huge impact on all the stakeholders. Signals about the upcoming bankruptcy are evident long before it occurs. The ability to read these signals and predict bankruptcy becomes important in the financial world. Effective analysis of the financial statements of companies can give us a fair idea on the potential threat of bankruptcy.

Balance sheet data is static for it measures a single point in time. The income statement, on the other hand, contains many non-cash transactions, whereas the cash-flow statement is dynamic. It records the changes in the other statements over a period and focuses on cash available for

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operations and investments. The value of cash flow information is that it can be used to assess the quality of earnings, financial flexibility and assists in forecasting cash flows. If cash flow ratios can be used as a liquid measure, that can predict financial failure and, ultimately, bankruptcy. Therefore, an early warning of possible distress can ultimately help to prevent subsequent financial failure.

Suitability of cash flow analysis as a tool for prediction of bankruptcy has been well researched and accepted.

Vikas: Cash flow statement? We did study this in graduation… I vaguely remember it has three sections measuring cash inflow and outflow from different activities…am I correct?

Rakesh: Impressed!!! That is a good recall. You are right. Cash flow statements comprise of three sections based on three activities: Operating, Investing and Financing. Each section represents the cash flow in that activity.

Operating Activities section shows the inflows and outflows of cash related to the basic operations of the business. For example, it would include cash received from debtors and cash paid to suppliers for purchase of inventory. Investing Activities shows cash flows which occur because of the purchase or sale of assets and creation or settlement of liabilities. From this section, you would get an idea of whether a company is buying assets or selling them. Financing activities depicts the cash flows arising from increases or decreased in the finances of the company. Some examples for this would be issue of fresh stock, buyback of shares, repayment of loans etc.

Vikas: Mmm I always failed to get this right… But how can this detailed data on cash inflows and outflows be useful in predicting bankruptcy?

Rakesh: Let me explain each section. The operating activity section is the engine of cashflow for the company. The proper working of this engine ensures enough cash to meet the operational cash needs. For a healthy growing company, this working capital would be growing which reflects from the growth in uses of cash like inventory and accounts receivables and in sources of cash like accounts payables. Obviously, there would be some variability from period to period but on an average, these components show a growth trend. Again, variations or aberrations can arise based on nature of the industry or economy; even though negative cash flow in one year is not considered as an indication of disaster, the operating cash flows are expected to be positive, on average.

On the contrary, for cash from investing activities, we look for a negative figure.  This is because a healthy growing company is expected to invest continuously in productive assets, either to replace old assets or to expand operations.  Although it is common of companies to sell off assets which have become obsolete or are no longer useful, for growing companies the expectation is that they purchase more assets than they sell.   Here to there are exceptions like when the company completely divests a business.

Cash flows from financing activities can either be positive or negative for a healthy growing company and most times, they are likely to fluctuate between the two.  In case the cash from operating activities falls short of cash from investing activities, then the difference amount needs to be sourced from either debt or equity and there would be a positive cash flow.  However, if the cash from operating activities is more than cash from investing activities, then the company has excess cash to pay off the debts and outstanding; hence, a negative cash flow.

Vikas:  That is amazing.  Now I can understand why you said that the cash flow statement is most useful for predicting bankruptcy.  So now tell me, how is the analysis of the cash flow statement done?

Rakesh:  Oh Boy!!! You have become such a curious learner….Can we also order some food? We have enough food for thought already!!!

Vikas:  Oh yes..let’s eat something too…

Rakesh:  Meanwhile, till the meal arrives, let's analyze these financial statements (Annexure).  I picked up the cash flow statements of three companies at work today. These companies, let’s call them A, B, and C, belong to the same industry.  With this data, let’s attempt to identify the performance of these companies: which company is on a growth path, which is a mature company, and which is a poor performer? Can we predict a potential bankruptcy in any of these three companies?

Vikas: That’s interesting.

Rakesh: Broad guidelines for analyzing these statements would be to first look at the operating cash flows. Assuming that they are positive, we need to check if they are adequate to meet routine expenditures. Next, we should look to see if there are any major cash requirements like debt repayment or share buyback. If there is, how are these funded, internally or from external borrowings? Are these expenses mandated or are they discretionary?

Vikas: Should this analysis be done in every case?

Rakesh: no, necessarily but there is a word of caution. If you do not do a full review, there are chance that you miss out on the whole story. When you are analyzing a cash flow statement, it is like doing a puzzle…you are reading many small details which build up to a complete story. Like people, no company is perfect. There would be good signs and bad signs. To arrive a proper, balanced conclusion, we need to understand the relative importance of each sign and build up the entire picture.

Would you like to try it?

Vikas: Of Course….

For the next hour, Vikas was fully engrossed in analyzing the cash flow statements of the three companies and, with occasional input from Rakesh, was successful in predicting the financial health of all three companies.

With a satisfied smile on his face, he relished his meal, which appeared more tasty….