

The cash flow statement shows a steady deterioration in CFO; albeit CFO remains positive. Income (before extraordinary items) on the other hand increases steadily at approximately 8%-10% per year. To explain the discrepancy between the pattern of income and CFO, we first compute the direct method cash flow statement and then compare the cash flow components with their income statement counterparts.

The (abbreviated) cash flow statement under the direct method is presented below:

	Years Ended December 31		
	1992	1993	1994
Cash from operating activities:			
Collections from customers	\$2,119,563	\$2,420,961	\$ 2,744,159
Payments for merchandise	(1,502,414)	(1,742,149)	(2,064,815)
Payments for SG&A	(453,449)	(523,474)	(601,575)
Interest paid	(37,883)	(33,367)	(33,948)
Taxes paid	(12,414)	(22,989)	(8,408)
Other (plug)	(13,263)	(247)	(4,619)
	\$ 100,140	\$ 98,735	\$ 30,794
Cash for investing activities:			
Capital expenditures	(48,878)	(110,534)	(90,009)
Acquisition of leaseholds	(30,602)	(21,894)	(8,025)
	\$ (85,480)	\$ (132,428)	\$ (98,034)
Cash for financing activities:			
Long-term borrowings	(3,276)	(23,831)	(19,432)
Revolving credit borrowings			70,243
Proceeds from sale of stock, options and warrants	1,995	54,460	1,050
	\$ (1,281)	\$ 30,629	\$ 51,861
Net change in cash	\$ 13,379	\$ (3,064)	\$ (15,379)

The required calculations for the operating items are presented in Exhibit 3S-2. The last item "other" is the plug amount used to arrive at the CFO presented in the indirect cash flow statement (Exhibit 3P-4).

## Exhibit 3S-2 Worksheet for Operating Items for Direct Method SoCF

	1992	1993	1994
Sales	\$ 2,127,684	2,414,124	\$ 2,748,634
Change in receivables	(8,121)	6,837	(4,475)
Cash Collections	\$ 2,119,563	2,420,961	\$ 2,744,159
COGS	(1,527,731)	(1,742,276)	(1,975,332)
Change in inventory	(28,401)	(60,893)	(82,863)
Change in accounts payable	53,718	61,020	(6,620)
Payments to Suppliers	\$(1,502,414)	\$(1,742,149)	\$(2,064,815)
SG&A expense	(458,804)	(520,685)	(605,538)
Change in prepaid expenses	1,317	(2,137)	(3,358)
Change in accrued wages	4,038	(652)	7,321
Payments for SG&A	\$ (453,449)	\$ (523,474)	\$ (601,575)
Interest expense	(39,934)	(34,904)	(34,948)
Amortization of debt issuance costs	2,051	1,537	1,000
Interest paid	\$ (37,883)	\$ (33,367)	\$ (33,948)
Tax expense	(25,507)	(26,152)	(27,569)
Change in taxes payable	9,003	2,662	17,567
Deferred taxes	4,090	501	1,594
Taxes paid	\$ (12,414)	\$ (22,989)	\$ (8,408)

The comparison of the cash flow and income statement components is presented below:

	1992	1993	1994	%change 1992-93	%change 1993-94	%change 1992-94
Sales	2,127,684	2,414,124	2,748,634	13.5%	13.9%	29.2%
Cash collections	2,119,563	2,420,961	2,744,159	14.2%	13.3%	29.5%
Collections/Sales	99.61%	100.28%	99.84%			
COGS	(1,527,731)	(1,742,276)	(1,975,332)	14.0%	13.4%	29.3%
Payments to suppliers	(1,502,414)	(1,742,149)	(2,064,815)	16.0%	18.5%	37.4%
Payments/COGS	98.34%	99.99%	104.53%			
SG&A expense	(458,804)	(520,685)	(605,538)	13.5%	16.3%	32.0%
Payments for SG&A	(453,449)	(523,474)	(601,575)	15.4%	14.9%	32.7%
Payments/SG&A	98.83%	100.54%	99.35%			

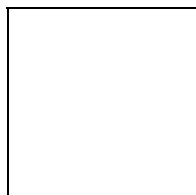
Credit and collections do not seem to be responsible for the deterioration in CFO. A comparison of cash collections with sales indicates that collections increased at a slightly faster pace than sales. The collections/sales ratio increased from 99.61% in 1992 to 99.84% in 1994.

Inventory, however, is another matter. Payments for inventory increased by 37% whereas COGS increased by only 29%. This is indicative of inventory being bought and paid for but not being sold. The proportion of payments to COGS increased accordingly from 98.3% to 104.5% in two years. This 6% increase translates (based on COGS of close to \$2,000,000) to an increased annual cash requirement of \$120,000.

Thus, the first cause of Radloc's problems seems to be inventories. Its income may be overstated as inventory may have to be written down if it cannot be sold. Even if inventory is eventually sold and the purchases now being made now are able to satisfy future growth, the firm may still face liquidity problems as it requires cash to purchase (and carry) the new inventory. However, as CFO is still positive the firm may still be a good candidate for credit.

Further insights as to the impact of growth can be seen if we compare free cash flow (CFO - CFI) with income and CFO.

	1992	1993	1994
Earnings before extraordinary items	\$37,262	\$41,378	\$44,359
CFO	100,140	98,735	30,794
Free Cash Flow	14,660	(33,693)	(67,240)



Although income rises, CFO and free cash flow fall. CFO exceeds income in 1992 and 1993 as the noncash depreciation add back increases CFO relative to income. By 1994, however, CFO, (although positive) falls below income. This indicates that the firm may have problems in covering the replacement of current productive capacity.

Free cash flow is negative in 1993 and 1994 and "barely" positive in 1992. This indicates that the firm's growth (in addition to inventory) requires cash that Radloc cannot supply internally.

Where did the cash come from?

In 1993, it met its cash requirements by issuing stock; in 1994 the firm's short term debt increased considerably as it drew down its revolving credit lines.

Thus, the loan should not be granted as the firm seems to be facing an increasing liquidity crisis.

Note: Radloc is an anagram for Caldor, a chain of discount stores. The data in Exhibit 3P-4 were taken from Caldor's published financial statements. Caldor filed for Chapter 11 bankruptcy soon after the 1994 statements were published.