BREVILLE
Funding surplus: $82.2m
Cash flow ratio: 1.23
Skaffold Score: A2

GUD HOLDINGS
Funding gap: $48.8m
Cash flow ratio: 1.32
Skaffold rating: B3

Mind the cash gap on balance sheets

Mark Story

There's no better insight into what is left for you as a shareholder in a listed business once it has paid all its bills than an analysis of its often overlooked cash flow.

When it comes to assessing the investment quality of a company's cash flow, you should be attracted to those with sufficient money in the bank to fund their ongoing operations and produce a funding surplus in the next financial year.

While every business operates to generate cash, you should steer clear of stocks with a funding gap.

A funding surplus or gap can be arrived at by subtracting the capital expenditure, investments and dividends paid from the company's cash flow generated from its operations.

The greater a company's funding surplus the more likely it is to avoid excessive borrowing, expand its business, pay dividends and withstand any economic headwinds.

You should be attracted to companies where the cash flow generated from operations and the funding surplus are trending upwards. Let's take a closer look at a real example. Here's what data from online share analysis tool Skaffold tells us about mining services company Clough's cash flows.

> Have a clear understanding of how the cash generated by a business has been used.

Given Clough's ability to produce a high proportion of cash earnings, it is viewed by Skaffold as in a strong financial position with no debt on its balance sheet. Clough is forecast to generate a return on its equity in excess of 16 per cent in 2014. Clough's 2013 funding surplus of $294 million gave a corresponding cash flow ratio of 1.95. As a result, Clough achieved Skaffold's second-highest (investment grade stock to buy) ranking of A2 for quality and performance.

Here's what Skaffold data tells us about appliance maker Breville's cash position. Between 2004 and 2013, the total of Breville's business activities when compared to cash flow from operations produces a funding surplus of $82.2 million, giving it a respectable cash flow ratio of 1.23.

Breville's funding surplus indicates it does not currently rely on external sources of capital to fund its business activities. Based on the strength of its low debt, healthy bank account, future ROE projections well above 20 per cent and healthy cash flow surplus, Breville has an attractive Skaffold score of A2.

Breville's direct competitor, GUD Holdings (manager of Sunbeam appliances) is also an attractive stock with a comparable cash flow ratio of 1.32, but once you factor in GUD's funding gap of $48.8 million it's easy to see which one you would rather own, and why GUD can only achieve a Skaffold rating of B3.

Be wary of well-known large-caps with unhealthy cash positions which may still attract uninformed investors because of their size and brand familiarity.

If you don't like the idea of trawling through a company's annual reports to make sense of its cash flow, draw on the analysis of trusted brokers or get financial professionals to do it for you.

SMSF BUSINESS LORE

Share trading expenses claims have all but gone

DIY super

Monica Rule

A question I am often asked is can a self-managed superannuation fund run a business?

Superannuation law does not specifically disallow an SMSF from conducting a business, but the activities of the SMSF trustee must not contravene the sole-purpose test or other provisions of the law. The provisions include:

- The sole-purpose test: a SMSF is there to provide retirement benefits or retirement-related benefits such as death or disability benefits for its members and dependants of the members. If an SMSF is conducting a business, it could be perceived its funds are being used to provide a current-day benefit to its members.
- Investment strategy: an SMSF trustee must formulate and execute an investment strategy. This means the business activities must fall within the SMSF's investment strategy.
- Lending: an SMSF trustee is prohibited from lending money or giving financial assistance to members and relatives. That means business activities must not involve selling an SMSF asset for less than its market value; buying an asset for more than its value; buying more services than required or paying an inflated price for services from members or relatives.
- Borrowing: an SMSF must not draw on a bank overdraft or margin lending to fund its business activities or borrow money or allow a mortgage to be placed on SMSF assets.
- Arm's length investments: an SMSF must not employ a member or a relative in the business at a salary higher than the going rate.

The reason the business question is asked is not because the SMSF trustees are thinking of starting a business, but because they are attracted to the concept of share trading and want to know if their SMSF can run a share trading business.

If a person is an ordinary shareholder the cost of buying shares is not an allowable deduction and losses from share sales cannot be offset against the income of an SMSF, but must be offset against capital gains on share sales. If a person is a share trader, they can treat the shares as trading stock and claim deductions for costs incurred in buying and selling.

The Australian Taxation Office determines which category a person belongs to on a case-by-case basis. The general rule is that a share trader is someone undertaking business activities to earn an income buying and selling shares. It is the volume and frequency of transactions that is important. Other factors include evidence of a business plan and keeping records in a business-like manner.

People need to be aware of a law introduced in June last year that abolished trading stock exceptions for SMSFs. It limits the ability of SMSFs to treat gains and losses from assets, such as shares, units and land on revenue account. Gains and losses will be treated under capital gains tax rules. If your SMSF held assets as trading stock before May 10, 2011, it can continue to be taxed on revenue account.

So whether your SMSF is conducting a share trading business or not, all SMSF share trading activities will now be treated as investment and capital gains tax applies. If you were thinking of a share trading business to avoid capital gains tax, you need to think again.

Monica Rule worked for the ATO for 28 years and is the author of the book titled The Self Managed Super Handbook – Superannuation Law for Self Managed Super Fund in plain English www.monicarule.com.au