Knowledge Horizons - Economics
Volume 9, No. 4, pp. 52 – 57 , © 2017 Pro Universitaria

"Dimitrie Cantemir" Christian University
Knowledge Horizons - Economics
Volume 9, No. 4, pp. 52 - 57
P-ISSN: 2069-0932, E-ISSN: 2066-1061
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www.orizonturi.ucdc.ro

NEED AND BENEFITS OF CASH FLOW INFORMATION

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Abstract

A company that consistently generates significant cash is also solvent, profitable and able to secure development. Therefore, the objective of a cash change statement is to provide information about the company's ability to generate cash and the way the company has used it during the financial year.

Profit and loss account gives information about flows, but not about cash flows, but about the income and expenditure flows. For a beginner in accounting, there is a tendency to consider each payment as cost and each cashing as earnings. However, the evolution of concepts of expenditure and income must take into account the gap that exists between the flows of goods and services (sales, purchases) and cash flows (receipts, payments). Therefore, it may happen for a company to obtain profit, but only a small part of it is included in the company treasury. When expenditure is recorded in the accounting records, payment might have been done in the past (rent costs were recorded in the N period although the rent had been paid in advance during the N-I period) or to be recorded in the future (registration of invoice for payment to a service provider).

Key words:
flows, cash-flow, cash flow statement

JEL Codes:
M41
Accounting

1. GENERAL ASPECTS

Cash flow is considered a leading indicator for financial analysis as it provides information on changes in components of cash values[1] between the beginning and end of a period, and, also, the structure of such change generated by the specific transactions undertaken by the company.

A company that consistently generates significant cash is also solvent, profitable and able to secure development. Therefore, the *objective* of a cash change statement is to provide information about the company's ability to generate cash and the way the company has used it during the financial year.

Historical information on cash flows represents the foundations of future cash flows' forecast, creating thus the premises to estimate the company's value. Also, this allows the assessment of the company's ability to generate cash flow, to determine cash needs, to provide maturity and risk of future earnings.

Most users of accounting information show considerable interest in the company treasury. Each of these users claims a part of it in the form of dividends, interest, wages, taxes, etc.

Information on company treasury is available in the balance sheet. It describes the company's cash position at the beginning and end of the fiscal year, but not the causes for any deficit or surplus cash.

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[1] According to IAS 7 Statement of Cash Flows, treasury items include cash and short-term financial investments, highly liquid, easily convertible into cash and with a low trading risk. U.S. GAAP, however, by SFAC 95 Cash flow statements, excludes from the treasury items, the current accounts credits (overdrafts/overdraft accounts), placing them in the financing activity.

However, the evolution of concepts of expenditure and income must take into account the gap that exists between the flows of goods and services (sales, purchases) and cash flows (receipts, payments). Therefore, it may happen for a company to obtain profit, but only a small part of it is included in the company treasury. When expenditure is recorded in the accounting records, payment might have been done in the past (rent costs were recorded in the N period although the rent had been paid in advance during the N-l period) or to be recorded in the future (registration of invoice for payment to a service provider). Also, some expenses do not affect cash flows (depreciation expenses and provisions) or relate to different inventories. When income is recorded, the collection might have been done in the past (the rent income was registered in the N period although the rent had been cashed in the N-1 period) or to be recorded in the future (recording a sale to a customer). Also, some income does not affect cash flows (income from provisions) or relate to inventories or property.

Having a Cash flow statement, users can assess changes in net assets of a company's financial structure and its ability to adapt to different circumstances and opportunities, to develop models to assess different companies.

We should not overlook that cash flow statement brings about the much desired reconciliation between the accounting result and cash flow. For this reason, IASB requires all companies that report in compliance with IFRS to prepare such a situation. In contrast, U.S. GAAP allows certain investment companies not to make such a situation.

2. ORIGIN AND DESTINATION OF FUNDS

Over time, in their attempt of systematization of information regarding the structure, origin and destination of funds used by the company, regulators have concluded that **liquidity changes** *can be explained by the action of three types of activities* based on a functional classification in the company:

1. *Operating* activities, defined in a residual manner, as the main income-producing activities and other activities that do not include investment or financing activities;

2. *Investment* activities, defined as those activities related to the acquisition and disposal of fixed assets and other investments not included under investments in cash equivalents;

3. *Financing* activities, defined as those activities that alter the size and composition of financing sources (equity and loans).

Both the international and the U.S. standard refer to the Cash flow statement format by the need to structure such a statement by detailing cash inputs (receipts) and outflows (payments) for each type of activity.

Although defined by resorting to financing and investment, the cash flow generated from operating activities is a vital indicator for measuring the financial performance of the company, its size depending on the company's capacity to generate sufficient cash for further investment, to provide dividends, to repay loans, all without resorting to external sources of funding. We must not forget the importance of forecasting future cash flows related to operating. In defining the composition of flow generated by operating activities, *IAS 7 Cash flow statements* creates a first connection with the company's outcome: flows related to operating activities generally result from transactions and other events that enter into the determination of net profit or loss. We can say, therefore, that the Cash flow statement changes the accounting result into an actually cashed result.

Although content is exemplified by receipts/payments related to various routine activities, methods of presentation allow a reporting by the direct or the indirect methods. The works of convergence undertaken by the IASB and FASB study options for reconsideration the cash flow requirements. The debate concerns the possibility of waiving the indirect method, but the possibility of maintaining the direct method as requirement of presentation, with information regarding the result-treasury reconciliation in the Notes.

3. CONTENT OF OPERATING FLOWS

Based on the *direct method*, the presentation of information consists of detailing receipts and gross cash payments arising directly from the accounting records or indirectly, by adjusting the sales and their cost with the variations of related assets or liabilities.

Supervisory bodies encourage the election of the direct method to respond to the reason of drawing a flow statement, to report by parallelism the cash input and output. The same requirements are found in the American normalization.

We list below the *content of operating flows* under the two ways of presentation:

Direct method

Collection of receivables
- Payment of commercial debts
- Payments of debts and social contributions
- Payments of taxes and duties
- Payments of operation related interests
+/- Collection/payments from natural disasters

To make such method more understandable, we suggest a computation based on the equation: *Initial balance + Inputs (confirmations) = Final balance + Outputs (discharges)*, which will position indicators on payments and collections according to the structures they are placed in the Trial balance.

The *indirect method* reports the same flow values as the direct method, but their coverage is different, starting from the accounting result (profit/loss for the period) adjusted with the effects of transactions that have no monetary nature, delays or liabilities and the cash flows from investment and financing activities.

A first method of determining the operation related flow is based on correcting the self-financing capacity adjusted with the variation of the working capital requirements and it is referred to as self-financing capacity. This can be discussed from two perspectives generated by variants of calculation: based on gross operating surplus or the net accounting result. According to the author, the second method is the *method of operation flows*, which can use the model presented in *IAS 7 Cash flow statements* and which we detail below:

Indirect method

Gross result
+/- Adjustments which do not generate cash flows:
+/- Adjustments for depreciation and provisions for impairment
+ / - Profit/losses from exchange rate related to claims or liabilities pending
+ / - Profit/losses from exchange rate related to current cash items
+ / - Adjustments which do not affect operation - financial income + financial expenses
= Operating result generating cash flow variations
+ / - Increase/decrease in trade receivables and operation related
+ / - Increase/decrease of inventories
+ / - Decrease/increase of operating debts (business, labor, tax, other than taxes).

The direct method is desired by investors because it allows the establishment of the company's value based on cash flow projections. The indirect method is preferred by managers, because hides from external users the real picture about the liquidity and solvency of the company, and by accountants, for ease of calculation.

The cash flow from operations, which mainly represents the difference between collections from customers and payments to suppliers and employees, provides investors with additional information, being a good indicator for measuring the company's performance.

Unlike the presentation requirements for operating flows, investment and financing flows must be submitted by the direct method, without making reference to the indirect method.

Cash flows from investment activities are reported as follows:

• The main classes of gross receipts in cash and gross cash payments are reported separately;

• Aggregate cash flows arising from acquisitions or disposals of subsidiaries and other business units are classified as investments.

Cash flows from financing activities are reported separately by presenting the main classes of gross cash receipts and payments.

Reporting is allowed on a **net** basis for the following cash flows:

• Cash flows on behalf of clients.

• Elements with rapid rotation, large amounts and short-term maturity (e.g., purchase and sale of investments).

The interest and dividends paid must be consistently treated as operating activities or as financing activities.

Cash flows from income taxes are classified normally as operating (except where specifically identified as financing or investment).

A foreign exchange transaction is recorded in the functional currency, using the exchange rate when cash flows occur.

Cash flows of foreign operations are translated using the exchange rates existing at the dates of occurrence of cash flows.

Where entities are accounted for by the equity or cost method, only actual cash flows generated by these entities (e.g. cashed dividends) are highlighted in the statement of cash flows.

Cash flows from joint ventures are included proportionally in the cash flow statement.

For classifying cash flows in one of three categories of activities, supervisory bodies provide a series of statements aimed at clarifying confusing situations:

- The interest paid and interest and dividends received are usually classified as operating flows and dividends paid as funding flows. *IAS 7 Statement of Cash Flows* allow the interest paid, as reflected of the cost of loans, to be included in the financing activity, the interest and dividends received, as a reflection of gains from loans and purchases of financial investments, to be included in the investment activity and dividends paid to be treated as payments resulting from the company's operating activities (part of the activity's outcome);

- The requirement on the classification of extraordinary items per three types of activities, although it would seem at first sight that does not ensure compatibility with the new version of IAS 1, that prohibits the display of a category of extraordinary items, does not contradict this requirement because items such as losses or gains from disasters will be presented separately because of their nature and will be classified either as financial items, or as actual operating items, or other operation items;

- Gains and losses arising from exchange rate changes of foreign currencies are recognized at a time and related to receivables and payables not yet settled, do not generate cash flows. Exchange differences relating to cash holdings will detail the state of the treasury and do not fall into one of the three activities.

- Income tax information is not required as separate information in the income and loss account, but an indication of *IAS 7 Cash Flow Statement* remains valid in terms of classifying income tax payments in one of the three categories.

The cash flow statement of required by *IFRS* shows the sources of cash inflows received by an entity during an accounting period, and the purposes for which they have been used.

The statement is part the analysis of an activity because it allows the analyst to determine the following:

- The company's ability to generate cash from its activities
- The consequences quantified in cash of the investing and financing decisions
- The effects of management decisions on financial policy
- Constant capacity of a company to generate cash

- How good the operating cash flow is correlated with net income
- Impact of accounting on earnings quality
- Information on long-term liquidity and solvency of a company
- If business continuity assumption is reasonable or not
- The capacity of firms to finance growth from internally generated funds

Since cash inflows and outflows represent objective information, the data presented in the cash flow statement are an economic reality. The statement reconciles the increase or decrease at the level of cash or cash equivalents of an entity that appears during the accounting period (objectively verifiable information).

Moreover, this statement should be read taking into account the following aspects:

- There are analysts who believe that accounting rules are created primarily to promote comparability, rather than to reflect economic reality. Even if this approach has been considered a tough one, it is true that much flexibility in accounting may raise problems to analysts, who are primarily interested in evaluating a company's future ability to generate cash from its activities.

- As the data from the profit and loss account, cash flows can be unpredictable from one period to another, reflecting random, cyclical and seasonal transactions, which imply cash and sectorial trends. Important trends can be difficult to decipher on the long term, starting from short-term fluctuations, less significant, of such data.

At the level of the European standardization, *the Fourth Directive* does not require the presentation of cash flow statements, but allows including other statements concerning financial statements with the balance sheet, the profit and loss account and annexes. Accordingly, Member States avoid requiring companies to draft and submit the cash flow statements in the companies' records, but encourages it. As a general practice, drawing a statement where liquidity is required to reflect changes in companies listed on international markets, namely those that prepare consolidated financial statements.

Until the amendment of the European Directive, the requirement of reporting the financial position was met by issuing a Funding statement, gradually replaced by the Flow statement.

4. CONCLUSIONS

In general, for a well managed and financially stable company, the cash derived from operating activities is higher than the net income; if not, the analyst must be skeptical in terms of the company's solvency.

Companies recoding growth often have negative free cash flows because their rapid growth requires capital expenditure and other investments with higher values. Mature companies often have positive free cash flows, while declining firms often have extremely positive free cash flows, because lack of growth means a low level of capital expenditure. Therefore, free cash flow with highly growing value is not necessarily positive or negative; they depend largely on the stage of the life cycle of the industry where the company operates. That is why free cash flow should be evaluated in conjunction with company's income related projections.

Many valuation models use operating cash flow, encouraging management to record entries as deriving from operation (normal and recurring) and outputs as related either investment or financing. Here are other areas where discretionary leadership elections could influence the presentation of cash flows:

- Payment of taxes. The management is interested in reducing taxes related to the current year, choosing accounting methods for the financial statement to defer payment of taxes for a future period.

- Discretionary expenditure. The management can manipulate operating cash flow by programming payments or bearing certain discretionary expenses

such as research and development expenses, repairs and maintenance and so on. Operating cash inflows can be increased also by programming the payment of deposits from long term contracts.

- Leasing. The entire output of cash related to an operating lease reduces the cash flow from operations; in what concerns the financial leasing, the payment is divided between exploitation and financing, thereby increasing operating cash flows.

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