Need to Revise Cash Flow Statement for Better Investment Decisions and Corporate Governance

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Abstract: This research paper makes a maiden attempt to suggest the improvements in the format of cash clow statement. Financial statements are made to report the stakeholders (i.e., shareholders, creditors, researchers etc.) which are published in the annual report of the companies. One of the financial statements is the cash flow statement. Cash flow statement present information by classifying in the three activities namely operating investing and financing activities. For investment decisions, more detailed information is required under these three activities. The authors in their belief have done a pioneering attempt by suggesting various improvements like incorporation of cash ratios, use of direct method of calculating net cash flows from operating activities and thereby making it mandatory. Authors have also recommended the five-or-seven year's cash flow statement be presented together in every annual report. The cash flow statement should also be converted as a common size statement either on sales or total assets basis. Once converted on common size statement, information becomes in ratio form. These ratios also generate information for decision making. We recommend, various professional accounting bodies in the world should ponder on these suggestions for providing additional information in the cash flow statement for investment decisions thereby increasing transparency and enhancing corporate governance.

Keywords: Cash Flow Statement, Format of Cash Flow Statement, Cash Flow ratios based on Cash Flow Statement.

Introduction

The importance of cash flows has been stated by James McNeill Stancill (1987) in his article 'Where is there cash in cash flow'. A company big or small runs on cash not on profits. One cannot pay its obligations and bills by profits; it is only cash. Cash is life stream of the business.

Jack Welch quoted "If I had to run a company on three measures, those measures would be customer satisfaction, employee satisfaction and cash flow".

The objective of writing this paper is to provide revised format of Cash Flow Statement to general investors specially the retail investors so that they can extract information for investment decisions. The retail investors are unable to get the ready-made information from financial statements for taking rational investment decisions. The bigger investors do get information from various sources like brokers, research agencies or consultants.

Let us go back to evaluation process of Cash Flow Statement. Approximately sixty years back from now (2021) there were two financial statements only namely Balance Sheet and Income statement depicting the financial information about the organization in India. There was no cash flow statement. But for running business smoothly one needs to know the cash inflows and outflows for taking investment decisions. Recognizing the importance of cash inflows and outflows, led us to develop the cash flow statement.

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As the time passed, Funds flow statement was recommended by researchers, accountants which was based on working capital basis depicting sources and application of funds. Working capital is needed to smoothly run business but it does not guarantee availability of cash which is of prime importance for smooth running of business. Therefore, emphasis shifted from preparation of funds flow statement (working capital basis to cash and cash equivalent basis highlighting cash inflows and cash outflows. Now cash flow statement is taken as a part of financial statement. Various accounting bodies have come out with accounting standard on cash flows FASB in USA, IASB and ASB in India etc.

Review of literature

[6]. Hamendra Kumar Porwal and Shashank Jain (2013) in their paper states that researchers and analysts have for long concentrated on conventional ratios (based on profitability, liquidity, and turnover) for evaluating company's performance and making predictions. Their paper highlights the importance of cash ratios (derived from the cash flow statement) for evaluating company's performance and use them to predict investment soundness.

[5]. Another paper by Porwal and Dr. Gyan Chandra* [5] (2004), have suggested number of improvements in Cash Flow Statement. According to them, cash ratios (non-conventional) should be disclosed as a part of the cash flow statement. Direct method of calculating cash flows from operating activities should be made mandatory. Format of the cash flow statement should have some improvements in it by disclosing more information to stakeholders for taking investment decision especially for retail and other investors.

[10] Naz Sayari, and F.N. Can Sigma Mugan in their research 'Cash Flow Statement as an Evidence for Financial Distress' analyzed the effect of cash flow components on bankruptcy risk and financial health of the companies. Four separate models were framed, and Linear Regression model was used to evaluate company age, company size, Cash Flows from operations, Cash Flows investing and Cash Flows from financing activities as a function of financial distress score of companies. Cash Flows from financing activities was found to be positively related with the financial distress score, while Cash Flows from investing activities did not provide any proof of financial distress.

[11]. The analysis of cash Flow becomes relevant specially under the accrual method of accounting where revenue is booked when sales transaction arises and not when the actual cash is received. Hence, company will be able report a higher revenue and net profits without even realizing the cash benefit from the transaction. The cash flow analysis emphasizes on such transactions that tend to inflate profit since cash flow statements reflect the effect of increase or decrease in trade receivables/debtors.

[11]. Cash is king. This is a maxim in the field of finance and investment. Despite of it, when we talk about financial ratio analysis, ratios related to cash flow rank among the most is ignored by investors. The analysis of income and profit, and assets and liabilities is important and receives due attention, the analysis of how the company deals with cash is critical as well.

[19) The article examined the effect of the cash flow statement on lending decisions of commercial banks with respect to companies listed in Vietnam. The study found that the information on Cash flow Statement has impact on the long-term and short-term lending decisions of credit officials and lowers down the confidence of lending officials. Therefore, their research is in support to improve the quality of cash flow statement to meet the requirements of the lending officials.

[20] Metka Duhovnik (2008) in article states cash flows calculated based on indirect method with respect to operating activities does not generate much additional information. The direct method of computing cash flows from operating activities improves and enhances the quality of information for decision making for small and other investors. Unfortunately, direct method is more based on the convenience of the organization and not identifying cash flows. His article emphasizes on generating additional relevant accounting information that should be provided to investors by a properly prepared statement of cash flows. For generating this additional information, ratio analysis should be done from both the aspect of profitability and cash return. Cash flow ratios would act as a control mechanism over the postulates/conventions/assumptions approached while preparing the balance sheet within the boundaries of reporting.

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Objective of the paper

Based on the review of literature discussed above, and the papers mentioned in the references, one can infer that additional information is required/to be disclosed in the financial statements especially in cash flow statement for stakeholders for investment decisions. A pioneering attempt has made by authors of this paper by suggesting the improvements in the format of cash flow statement. The relevance of the cash ratio cannot be overlooked. Various cash ratios have been devised with their formula in the coming section taking care of profitability, turnover, and solvency aspects as is being done in case of conventional/traditional ratios.

Format of Cash Flow Statement

Presently Cash flow statement identifies the cash inflows and cash outflows in operating, financing, and investing activities. It is of utmost importance for the organization to generate cash inflows from its main operating activity to run business successfully. Essentially the scope of financial management revolves around managing and balancing three decisions 1. Financing decisions 2. Investment decisions and 3. Dividend decisions. These three decisions can very well be understood by analyzing the cash flows (inflows and outflows) in the cash flow statement. Any funds raised by the company from the stakeholders (Financing decision) are invested (Investment decisions also known as capital budgeting decisions) in long lived and short-term assets (working capital management). The stakeholders have expectations in the form of returns (i.e., dividends). All this information essentially relating to these three decisions, one can extract from cash flow statement for analysis and thereby helping in taking rationale investment decisions specially by the retail investors. We are suggesting a revised format of cash flow statement which will generate better and transparent information for investment decisions for retail investors, other investors and researchers as given below:

The proceeds from long-term borrowings under the head Cash flows from financing activities to be shown as follows:

1. Repayment of long-term borrowings (Principal amount) of each of the past year showing separately in the current year's cash flow statement.
2. Repayment of long-term borrowings (Principal amount) of the current year's cash flow statement.
3. Repayment of long-term borrowings (Interest amount) of each of the past year showing separately in the current year's cash flow statement.
4. Repayment of long-term borrowings (Interest amount) of the current year's cash flow statement.
5. Long-term borrowing not yet paid but due including interest of past years.
   (Not a part of cash flow statement but can be as an additional note to cash flow statement as it is based on accrual accounting along with reasons.

A ratio based on the above five situations each can be calculated by taking the figure of net cash flows from operating activities as a numerator. These ratios will provide information to investors i.e., whether company is able to pay principal amount and interest due on long-term borrowings out of cash generated from operating activities of the company efficiently or not. If the ratio is increasing over a period, it is sound from the point of view of investment decisions. To highlight specifically, it like the creditor's turnover ratio leading to Loan repayment ratio (LRR). LRR measures long-term solvency ratio and reflects the capability to pay the long-term debts from the cash generated from the operations. Higher the ratio the better it is).

Since every company expedites the recovery from debtors for better management of receivables, it should also take care the payments (Principal amount and interest) are paid in due time. If payments are not made in time, it provides negative signals, that it is not generating enough cash flows to pay its obligations at the right time.

These ratios (as suggested above) generate information based on past. For investment decisions, one also needs to know the information about likely payment in future about its long-term debts. Therefore, aging schedule of the long-term debts with respect to payments (also of trade creditors) be disclosed in the cash flow statement as an additional note. Aging schedule of creditors is as relevant in management of payables (both trade and others long term creditors) as it is in the efficient management of receivables/debtors' management. The advantage of this disclosure is going to identify the non-performing assets in a firm because nonpayment of borrowings (debt and interest) in time is equally a problem of non-receipt of borrowings (including debtors) given by the other firm.

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This would make it easy in early identification of non-performing assets. Role of auditors of the company is of prime importance to disclose this as a note to cash flow statement. We believe, this categorization (based on the time say one, two or three months depending upon the firm's policy) is especially important for investment decisions by the stakeholders and will bring about effective corporate governance in disclosing transparent information.

Various accounting bodies have issued accounting standard on cash flow statement all over world. Ind. Accounting standards no. 7 is applicable in India in this respect. These accounting standards on cash flow statement recommends for finding out cash flows from operating activities based on indirect and direct methods.

Indirect method is preferred method by the companies as it is easy for them (as argued) to calculate the cash flows from operating activities. One must add back non-cash items in the net profits to get the net cash flows from the operating activities. However, more information is disclosed if direct method is used in finding out the net cash flows operating activities. Direct method provides information about the receipt of cash from debtors, which very a significant information about the realization of cash from debtors as sales are essentially done the credit basis in the companies. As already discussed above, Aging schedule of debtors classifies debtors in the basis of time. Based on the aging schedule one can visualize the uncertainty about the realization of debtors in future. Hence, in our opinion, direct method must be made mandatory by various accounting bodies in finding out the net cash flows from operating activities. However, indirect method may also be used as a recommendatory method. Therefore, an amendment is needed in this respect by various professional accounting bodies like FASB, ASB, ICAI(India), and in Ind. Accounting standard No.7.

Another disclosure aspect, that is needed, is the cash ratios (calling them as non-conventional) calculated largely based on cash flow statement. So far ratios are calculated are largely based on the 1. Profitability 2 Solvency (both long-term and short-term) 3 Turnover/efficiency and some other. These ratios (calling them as conventional ratios) are largely based on income statement and Balance sheet.

Emphasis has been given in calculation of non-conventional ratios on the figure of net cash flows generated from operating activities of the company. It is on the assumption that if sufficient cash flows are generated from operating activities, one can say company is doing well in its business activities. The non-conventional cash ratios based on profitability, solvency, turnover, and efficiency are listed below along with the formulas.

1. Profitability ratios

   CFOP below refers to cash flows from operating activities.

   (a) Cash return on sales ratio = CFOP/Net sales
   Higher the ratio, the better it is for the company. A trend in the ratio over the years can be observed for deviations. A fluctuating trend reflects the operational weakness.
   (b) Cash return on Capital Employed = CFOP/ Capital employed
   (c) Cash return on Equity Shareholders= CFOP/Shareholder's fund
   (d) Cash return on assets ratio = CFOP/Total assets

2. Solvency ratios

   (a) Short-term solvency

   (I) Current cash debt coverage ratio = CFOP/current liabilities
   (II) Cash interest coverage ratio = CFOP/interest paid (current year only)
   (III) Loan repayment ratio = CFOP/Repayment of loan (current year only)

   (b) Long-term solvency

   (i) Cash debt coverage ratio = CFOP/Total debt
   (ii) Debt Issued ratio = CFOP/debt issued

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3. Turnover ratios

   (a) Working capital cash flow ratio = CFOP/working capital
   (b) Inventory cash flow ratio = CFOP/ inventory
   (c) Fixed assets cash flow ratio = CFOP/Net Fixed assets
   (d) Capital expenditure ratio =CFOP / (CFOP - Capital Expenditure)

CFOP – Capital expenditure = free cash flows
When CFOP is weak, A company depends more on external financing, which increases the risk of indebtedness. To check this, investors can divide free cash flows from cash flows from financing activities. A lower ratio means more dependence on external financing.

4. Linking three activities ratio

   (a) Operating and financing activity ratio = CFOP/ (Net cash inflows from financing activity)
   (b) Operating and investing activity ratio = CFOP/Cash flows from investing activities
   (c) Investing and financing activity ratio = (Net cash inflows from investing activities) /Net cash flows from financing activities
   (d) Cash flows from investment and financing ration = (Net cash flows from investing/net cash inflows from financing activities)

5. Other ratios

   (a) Cash earning per share ratio = cash for equity shareholders/ No. of shares
   (b) Dividend pay-out ratio = Dividend per share/cash earning per share
   (c) Price earning per share ratio = Market price per share/ cash earning per share

Suggestions

1. Various accounting bodies in the world have issued accounting standard on cash flow statement. The quality of reporting in the cash flow statement is not sufficient. It does not generate much of the additional information for taking investment decisions by various stakeholders. More detailed information is needed in presentation of
   Proceeds from long-term borrowings
   Payments of long-term borrowings
   Aging schedule of debtors and aging schedule of creditors be given as note to cash flow statement.
2. Cash ratios should be calculated taking care of profitability, turnover, solvency, and other aspects. Cash ratios should be a part of note to cash flow statement. Cash ratios should be clearly defined. Numerators and denominators of each ratio should be clearly defined i.e., having no leverage of other interpretation depending upon the company belongs. The numerator and denominator figures should be certified by the auditors of the company based on the books of accounts.
3. A graphical presentation of all these ratios should be presented. it is going to enhance the transparency leading to the increased corporate governance. These ratios should be calculated for the last seven or five years, if possible, by highlighting higher the ratio, better it or lower the ratio, better it is. It can provide the clear trend (increase or decreasing) of a particular ratio which will be especially helpful to small investors in taking the decisions.
4. So far, the format of cash flow statement of the companies in India discloses information of two years only (i.e., one on current year and the other one is preceding to it). In our opinion, the figures for seven or five years should be disclosed. Cash being the king, more information in terms of period say again seven or five years is required to be disclosed for delivering additional information to investors. This is going to bring about better transparency and corporate governance.
5. Direct method of calculating net cash flows should be made mandatory. However, companies can be encouraged to disclose the calculation by both the methods. Direct method generates better and clearer picture about the receipt by debtors. Profits do not pay the bills and obligation; it is the cash. Direct method overcomes the limitations of accrual accounting.

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6. Cash flow statement should also be shown as a common size statement either based on percentage sales or total assets. Once cash flow statement converted on common size statement, it depicts ratios and trend can be developed for taking decisions.
7. Various professional accounting bodies should dwell upon the several suggestions pinpointed above and should change the accounting standards on cash flow statement in their respective country accordingly. We believe, this would increase the transparency and enhance the corporate governance.

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