Comprehending the Role of Cash Ratios for Better Investment Decisions

Dr. Sangeeta Porwal

(M.Com, M.Phil., PhD, ICWA)
Associate Professor, Dyal Singh College
University of Delhi

DOI: https://doi.org/10.56293/IJMSSSR.2022.4505

IJMSSSR 2022
VOLUME 4
ISSUE 5 SEPTEMBER - OCTOBER **ISSN: 2582 - 0265**

Abstract: For better investment decisions, the role of the cash ratios is of prime significance. Cash ratios produce additional information besides the information that is generated by accrual-based ratios. The paper has identified the various cash ratios. These cash ratios (calculated say for 5 or 7 years) generate a trend, which when analyzed, generate information for better investment decisions. The general investors must analyze these ratios before making investment decisions.

Keywords: Cash Flow Statement, Cash Ratios, Investment Decisions

Introduction

Financial statements of the companies are prepared for providing information to various stakeholders. Various stakeholders in the company can be shareholders, creditors, governmental agencies, financial institutions, researchers, employees etc. The prospective investors can also become stakeholders. Various investors invest the money in the company to get proper returns with least risk.

The objective of financial management is essentially concerned with financing decisions investment decisions, dividend decisions, and the effective working capital management. All these decisions ultimately boil down to providing proper returns to it investors. Investors especially wait for returns in the form of dividends and maximization of value in the share in the company in which they invest.

Every investor before investment in the shares of the companies search for proper and correct information. It is the financial statements of the companies (Income Statement, Balance Sheet, and Cash Flow Statement) that provide this information. But what information is to be extracted and in what form from the plethora of information mentioned in the financial statements, is big a challenge for the general retail investors. The information may not be readily available. Therefore, it is needed to relate the figures and other information given in financial statement to generate the meaningful information for investment decisions. A judicious use of cash flow statement is of prime importance to generate the information.

Cash flow statement presents information about the company's cash inflows and cash out flows during a financial/accounting year. This cash-based information in the cash flow statement is in contrast with accrual-based information from the Income Statement. For e.g., Income Statement considers revenues when earned while Cash Flow Statement considers it when cash is received. Reconciliation between the reported income and cash flows from operating activities is done by using indirect method. This reconciliation, no doubts, provides useful information, but there is no information when and how a company will be able to generate cash from its operating activities. There is no information in its income statement, how will it be able to recover from the trade debtors. Hypothetically, a company recording all sales in income statement but with no cash inflows, the company would not remain in existence. Therefore, importance of cash flows cannot be ignored. Equally, one must accept that income is an integral measure of the performance of the company.

Before making investment, analyst, or any investor (whether retail or FII or DII) must think over the following few questions and must make a humble attempt to get answers to these questions.

1. Whether it generates sufficient cash from its operations to pay off for its new investments?
2. Is the company depending on new debt issuance to finance the new investments?
3. Is the company paying dividend to equity shareholders either from the cash generated from cash flows, from selling assets, or from issuing debt?

Successful debt financing is possible only when the lenders to the company are willing to lend. Their lending decisions depend on the expectations that company will generate ample cash to repay its debt or other obligations. Answer to the above questions can be obtained once the proper analysis of the Cash Flow Statement of the company is done.

Why this paper?

The purpose of writing this paper is to emphasize on the role of cash ratios for better investment decisions on the part of investors. For any investment decisions in the company by the investors, the company's cash position should be analyzed. Stronger the cash generation capacity, stronger is the financial soundness of the company. What is the source of cash generation i.e., is it generating mainly because of operating activity, or by some other activity? The cash ratios generate lot of additional information on the availability of cash. Hence, due emphasis is to be given by the investors in calculation of cash ratios of the company in which they invest money. This will make it feasible for taking better investment decisions.

Review of literature

[1]. Dung Duc NGUYEN, Anh Huu NGUYEN (2020) in their paper titled "The Impact of Cash Flow Statement on Lending Decision of Commercial Banks: Evidence from Vietnam "examines the impact of the statement of cash flows of listed companies on lending decisions of commercial banks in the context of Vietnam. The survey findings indicated that cash flow statements were important for lending decisions of credit institutions in Vietnam. According to them, the paper provides a new insight to managers on how to improve the quality of cash flow statement to meet the needs of lenders.

[2]. Cash ratios are useful for predicting financial distress. The study done by L. Jooste (2007) evaluates the usefulness of cash flow ratios to predict financial distress. Despite, A company having positive liquidity ratios and increasing profits, yet may have serious cash flow problem. Cash Ratios developed from the Cash Flow Statement provide additional information besides the information generated by the traditional accrual-based ratios for analyzing financial soundness of an entity. Ten failed entities were selected (for the study) for a cash flow evaluation by means of the eight selected ratios for five years prior to failure. The study revealed that cash flow ratios have predictive value with the cash flow to total debt identified as the best indicator of failure.

[3] The article titled "Performance Measurement Through Cash Flow Ratios and Traditional Ratios: A Comparison of Commercial and Casino Hotel Companies", by Kisang, Tyu Shawn Jang (2004), found that traditional ratios generated different results from cash flow ratios in liquidity. Casino hotel companies were found to have significantly higher liquidity ratios than commercial hotel companies, indicating a possibility that the difference may be caused by the type of hotel.

[4]. Metka Duhovnik (2008) in their paper titled "Improvements of the cash-flow statement control function in financial reporting", emphasized (based on the finding) that professional literature was inconsistent in distinguishing liquidity and profitability information and consequently also in distinguishing between the ratios calculated on that basis. An additional value of accounting information that can be given to the users of financial statement by properly prepared cash flow statement.

Analysis

It is entirely based on the calculation of various ratios on the part of general investors. We have identified various cash ratios that should be computed and interpreted by the investors. For computing cash ratios, Cash Flow Statement can be used, which is always available in the annual report of the company.

Ratio is relationship of any two quantitative figures to draw out meaningful information. Ratio analysis is one of the important parts of fundamental analysis. The cash ratios can be computed from the figures in the Cash Flow Statement. Ratios can be based on the performance/solvency/turnover etc., Cash flow statement has three subsections relating to operating, investing, and financing activities. The cash ratios with respect to each of the activities can be calculated. However, for measuring the performance of the company, performance ratios can be calculated, the formula and the purpose each of these ratios is mentioned below:

CFFOPA represents Cash flow from operating activities.

1. Cash flow to revenue ratio (CFFOPA /Net revenue) – The ratio measures the cash generated per Rupee of revenue.
2. Cash return on assets ratio (CFFOPA/ Average total assets) – The ratio measures operating cash generated per rupee of the asset investment.
3. Cash to income ratio (CFFOPA/Operating income) - It measures the cash generating ability of operations
4. Cash return on equity ratio (CFFOPA/Average equity) – The ratio measures cash generated per rupee of owners' investment
5. Cash flow per share ratio (CFFOPA for equity shares/No. of Equity shares outstanding) – The ratio measures operating cash flow on a per share (equity) basis.

Coverage ratios are concerned with measuring long-term and short-term solvency.

6. Debt coverage ratio (CFFOPA/Total debt) –It measures financial leverage
7. Reinvestment Coverage ratio (CFFOPA/Cash paid to purchasing/acquiring assets with operating cash flows) – It measures ability to purchase assets with operating cash flows.
8. Interest coverage ratio (CFFOPA/interest paid) - It measures ability to meet interest obligations.
9. Debt Payment ratio (CFFOPA/Cash paid for long-term debt repayment) – It measures to pay debt with operating cash flows.
10. Interest and financing ratio (CFFOPA/cash outflows for investing and financing activities) – It measures ability to purchase/acquire assets, pay debts and make distributions to owners.
11. Current ratio (CFFOPA/current liability) – It measures the ability to pay current liability out of Cash flow from operating activities.

Turnover ratios

12. Working capital cash flow ratio (CFFOPA/working capital) – It measures the rotation of working capital with respect to cash from operation.
13. Inventory cash flow ratio – (CFFOPA/Inventory) -It measures the rotation of inventory with respect to cash flow from operation.
14. Capital expenditure ratio – (CFFOPA/ (CFFOPA-Capital expenditure) - It Measures Availability of cash for capital expenditure.

Activities relationship ratios

15. Operating and financing activity ratio (CFFOPA/Net cash inflows from financing activity) – Shows comparability of available cash flows from operations in comparison with respect to financing activity.
16. Operating and investing activity ratio (Net cash flows from investing/net cash inflow from financing).

Suggestions

The conventional ratios (based on accrual-basis) do generate information for decisions which is one of the important gradients of fundamental analysis. However, Cash ratios listed above (cash-basis) also generate the additional information for decision making. Therefore, it may lead to better investment decisions (i.e., trend analysis say 5 or 7 years). The retail investors must look for this kind of analysis before making the investment decisions. Although, FII and DII have their own research cell to do this kind of analysis, which is not available or known to retail or small investors.

References

1. NGUYEN, Dung Duc , Anh. 'The Impact of Cash Flow Statement on Lending Decision of Commercial Banks: Evidence from Vietnam', Journal of Asian Finance, Economics and Business, Vol 7, Issue 6, p 85-93/2020.
2. 1. Jooste, L. (2007). "An Evaluation of the Usefulness of Cash Flow Ratios to Predict Financial Distress", Nelson Mandela Metropolitan University, Port Elizabeth, South Africa.
3. Kisang, Tyu Shawn Jang (2004). "Performance Measurement Through Cash Flow Ratios and Traditional Ratios: A Comparison of Commercial and Casino Hotel Companies", Journal of Hospitality Financial Management, Management Educators Vol. 12, No.1.
4. MetkaDuhovni, 'Improvements of the Cash-Flow Statement Control Function in Fi nancialReporting" Zb. rad. Ekon. fak. Rij. • 2008 • vol. 26 • sv. 1 • 123-150 123 Review article UDC: 657.4:657.3
5. Joose, Leonie (2006) "Cash Flow Ratios as a Yardstick for Evaluating Financial Performance in African Businesses", Managerial Finance, Vol. 32 No. 7 p.569
6. Mills, John R. and Jeanne H. Yamamura. "The Power of Cash Flow ratios", Journal of Accountancy, Vol 186, No.4, October, pp 53-61s
7. Naz Sayari, F.N. Can Sigma Mugan. "Cash Flow Statement as an Evidence for Financial Distress", Universal Journal of Accounting and Finance, 1(3), 2013, p 93-103.
8. Ranjit Shinde. "Here's How to use Cash Flow Ratio Ratios to Place Your Bets", The Economic Times, New Delhi, Wednesday, 14th September 2016, P 12.
9. Ashish Singh and David Sweig, 'Cash is Not Only the King, it's Strategic'. The Economic Times, Wednesday, 23 September 2009, p 12.
10. Geller, N., Ilvento, C. L., &Schmidgall, R. S. (1990). Update Your Accounting with Cash Flow Statements. Lodaina, 15 (10), 54-56. Journal of Accountancy, 175 (3), 55-58.
11. Giacomino D.E., and Mielke, D.E. (1993). 'Cash Flows: Another Approach to Ratio Analysis', Journal of Accountancy, 175 (3), 55-58.
12. Beck, D.F. 'Cash is King'. Health Care Supervisor. 13(1) p 1-9.
13. Zeller, T. L., & Stanko, B. B. (1994). 'Operating Cash Flow Ratios Measure a Retail Firm's Ability to Pay.' Journal of Applied Business Research, 10 (4), 51-59.