

## The cash flow - instrument for the company's analysis and forecast

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### **Abstract**

*Cash represents the firm's vascular system. The fact that a firm is profitable does not mean that it is also solvent. The profit is not the cash. Cash flow analysis involves cash movement analysis to and from the business in order to determine the actions that produce and consume cash in an operating cycle. Cash flow analysis is essential; especially for the cash lenders because it is the only instrument that can accurately measure the amount of cash needed to cover the rates and payment interest in the following years and can identify the origin of that cash. Some companies report impressive profits, which do not have a correspondent in cash. This is due to management quality on the one hand, and on the other the accounting conventions which underlie the accounting result. The user of accounting information must delimitate the data which is the result of the accounting result.*

*Cash flows are useful in making predictions on the future cash flows, assessing management quality, liquidity and solvency assessment and analysis of the relation between the accounting result and cash flows of the company. Together with balance accounting and profit and loss account, the cash flow provides relevant and reliable information in assessing the financial position and the performance of the business.*

Keywords: cash flows, net treasury, financial ratios, forecast, direct method, indirect method

JEL classifications:

L - Industrial Organization  
L2 - Firm Objectives, Organization, and Behavior  
L21- Business Objectives of the Firm  
M - Business Administration and Business Economics; Marketing; Accounting  
M4 - Accounting and Auditing  
M40 - General  
M41 - Accounting

### **NECESSITY AND BENEFITS OF INFORMATION ON CASH FLOWS**

Financial statements translate the financial activity of the enterprise into a more or less objective set of numbers, which provide valuable information about the firm's performance and about its possible problems and its potential in the future.

Most users of the accounting information are particularly interested in the cash of the company that publishes its financial statements:

- Internally, managers need to know the current financial position of the firm (performance and problems), continuing with problems and control functions;
- Suppliers are interested in the firm's liquidity because its rights are generally on a short term and in this case the company's ability to pay is best reflected by the liquidity indicators;
- Investors in bonds, who ordinarily lend the firm on medium or long term for a remuneration, are rather interested in the company's ability to generate cash flow for medium and long term coverage of debt service. Here the firm's capital structure plays an important part, cash conversion cycle and profit evolution;
- Investors are interested in profit evolution, volatility and stability and its tendency over time;

Information concerning enterprise treasury is available in the balance sheet. This presents the firm's treasury position at the beginning and at the end of a period, but not the causes for possible lack or surplus in treasury. Profit and loss account provides information about revenue and expenses flows, but not about treasury.

Cash flows represent all inputs and outputs liquidities and cash equivalents. Liquidities represent cash on hand and demand deposits. Cash equivalents are short-term investments with a liquidity degree that can be easily converted into cash with an insignificant risk of value change.

Cash flows are useful for the following reasons:

- the cash flows' objective nature;
- adaptation of cash flow statement to the estimated analysis;
- the treasury is an important indicator of the enterprise's management and bankruptcy risk analysis;

The treasury allows the company to finance its business assuring its continuance. The size in absolute and relative values and treasury evolution can characterize a certain state of the firm: financial balance, vulnerability, bankruptcy, etc.

Functional presentation of cash flows facilitates elaboration of financial projections, which allow sharing cash flows for each operating activity and cash flows investments and financing activities.

The solvency, flexibility and the financial performance of the firm are set on the firm's ability to generate positive cash flows from the operating activity.

For a just assessment of financial performance and financial risk it is necessary to calculate the financial rates based on cash flows, balance sheet or profit and loss account.

#### **FINANCIAL RATES USED IN CASH FLOWS ANALYSIS**

Some of the most used rates are:

- rates assessing the solvency and the bankruptcy risk:
  - 1) Operating cash flow rate = net cash flow from operating activities/current liabilities.

This ratio shows the firm's ability to generate the financial resources required to cover the current debt.

2) Cash interest coverage = (net cash flow from operations + interest + taxes)/interest.

This rate indicates the firm's ability to pay interest on the liabilities. A sub unitary value (<1) must be a wake up call for investors and analysts.

3) Liquidity sales ratio = net cash flow from operating activities/turnover.

• Rates assessing the firm's financial health and its capacity to cope with the financial commitments:

1) Cash Current Debt Coverage (CDC) = (net cash flow from operating activities - dividends)/current financial liabilities. This rate shows the firm's ability to pay back its future financial debt.

2) Total Debt Ratio = net cash flow from operations/ total debt. This ratio shows the firm's ability to repay its future debt, namely the amount of time necessary to repay the total debt.

• Rates which assess the ability of the firm to finance its own development:

1) Capital Expenditure Ratio = net cash flow from operations/ investment in tangible assets.

2) Cash flow Adequacy Ratio - CFA = (profit before amortization - interest expenses - tax profit)/ maturities' mean scheduled for the next five years.

Financial ratios calculated on the net flows provide useful information on liquidity and solvency analysis of firms. In order to avoid erroneous conclusions on the financial position and the firm's performance it is necessary to make prudent interpretations of these rates, considering the average level of the average values recorded in the industry that the firm is part of.

#### **ACTIVITIES THAT GENERATE CASH FLOWS**

It is required for the firm to present the cash flows from operating activities, investing activities and financing activities according to the functional approach of these activities.

• Cash flows generated by operating activity.

According to IAS 7, the main activities generating revenue are the operating activity and any other activity not included in the category of investments and financing activities:

1) Cash proceeds from goods sales and service delivery.

2) Cash proceeds from royalties, fees, commissions and other income.

3) Cash proceeds from loan interest and investment dividends.

4) Cash proceeds and payments of income taxes, provided that they cannot be associated with investing and financing activities.

5) Payment to suppliers of goods and services, other than the property providers.

6) Cash payment to employees and in their names.

7) Cash payment of interest for loans.

Cash flows generated by the operating activity shows the firm's ability to generate cash flow to repay loans and financial leasing rates, keeping the firm functional, dividends payment and proceeding to new investments from self-financing.

- Cash flows generated by the investing activity

According to IAS 7, cash flows generated by the investing activity show to what extent was payment made in order to acquire income generating assets and future cash flows. The following cash flows derive from the investing activity:

- 1) Proceeds from tangible and intangible sales and other long term assets.
- 2) Payment made for tangible and intangible purchase and other long term assets, including the capitalized development expenses and payment arising from the properties realized from its own production.
- 3) Cash proceeds from the sale of equitable title and debenture issued by other firms and interest in joint venture.
- 4) Cash proceeds from repayment of advances and loans granted to other parties.
- 5) Cash payment for acquisition of its own equity instruments or other firms' debts and interest in participation associations.
- 6) Cash advances and loans granted to third parties.
- 7) Proceeds from repayment of treasury advances and loans granted to third parties.

- Cash flows generated by the financing activity

The financing activity is according to IAS 7 the activity that produces changes in size and structure in the firm's equity and loans. The value of these cash flows is relevant for the estimation of future cash flows expected by the firm's financiers. The following can be considered cash flows generated by the financing activity:

- 1) Cash proceeds from shares or other equity instruments.
- 2) Proceeds from the emission of bond loans, banking, treasury bills, mortgage loans and other short or long term loans.
- 3) Payment made to shareholders for the acquisition or repayment of the enterprise's share.
- 4) Repayment in cash of the borrowed amounts.
- 5) Cash payment of dividends to shareholders.
- 6) Payment made by the lessee to reduce the debt relating to a financial lease.

The result of cash flows from operating activities, investing activities and financing activities represents the net treasury.

#### **Methods of cash flows presentation for operating activities**

A firm must present the cash flows from operating activities using one of these two methods:

1) The direct method in which the proceeds and operating payment are presented in gross size.

2) The indirect method in which the net profit/net loss is adjusted with the transition effects that don not have a monetary nature, any postponements or commitments of cash payment or cash proceeds from past or future operating activities and revenue and expenses elements associated to cash flows from investments or financing.

The **direct method** is the method indicated for accuracy and detail of the cash resources presentation to be used by firms to report cash flows from the operating activity, being useful for estimating future cash flows. Information on proceeds and payment can be obtained from the firm's financial documents or adjusting sales, cost of sales and other elements of profit and loss with changes in inventories, receivables and payables of the analyzed period, with elements that do not generate cash flows and with elements that influence cash flows from investing or financing.

With the **indirect method** the net cash flow is determined by adjusting the net income to non-cash items, such as: amortization, provisions, deferred taxes, unrealized foreign currency gains and losses; changes occurred during the period of inventories and in receivables and liabilities; items which affect cash flows from investing and financing activities.

#### **Cash flow forecasting**

Financial forecasting is not easy. Lately it is even more difficult as the macroeconomic environment has become more volatile. Managers are called upon to use their intuition and business skills to predict the future of the business. They have to manage financial flows with fairness to ensure the long lasting success of the company.

Cash flows forecasting require the estimation of all future cash resources of the firm. Projected cash flows must take into account the tendency manifested in the past, the estimated changes in operating activities, the investment policy, the features of the financing contract, seasonality and changes in the political and fiscal business environment.

Cash projection analyzes and identifies important aspects of the financial management:

- Differentiation between the firm's ability to achieve profit and generate positive cash from operations
- Net cash flow from future operations to cover loan payment and financial leasing, future investments or dividends
- The firm's need for further financing
- Future effects on financial flows, of cash or non-cash transactions concerning investments and financing

Regarding the calculation of net treasury, the international accounting standard IAS 7 recommends the firms to use the direct method because this method provides useful information in cash flow forecasting which is not available with the indirect method. In order to get a cash flow forecast through the indirect method, the financial model is based on financial statements that will provide future levels of assets and liabilities balances, as well as the anticipated profit levels.

Profit and loss account can offer a projection of the profit level that a firm's

management estimates to achieve on a certain period. For profit forecast the following aspects are taken into consideration: estimating future sales, defining a production program and calculating the cost of the sold goods; calculating the other expenses and determining the profit.

### **Conclusions**

The cash flow model obtained by the direct method is useful mostly to satisfy investors' necessity for information, who can estimate the future cash flows and consequently the dividends they could collect in future financial exercises. This model's disadvantage is the use of a complicated and laborious method. The cash flow model obtained by indirect method is clear and simple and provides information on the "balance" or "imbalance" of the firm's balance sheet produced by management decisions or the absence or presence of cash to cover all payment categories in the forecast period.

The disadvantages of this model are: first, dependence on sales projections, an element difficult to anticipate in the context of a highly volatile business environment and second, it does not capture seasonality and risks, related with the seasonal peaks and the financing needs.

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