

THE CONTRIBUTION OF CASH FLOW INDICATORS IN TERMS OF INFORMATION TO THE COMPANY PERFORMANCE ANALYSIS

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Abstract: The necessity of cash flow appears in the context of the limits of the balance sheet and of the profit and loss account in the reflection of the financial and accounting information. Although the profit and loss account provides a dynamical image of the activity of a company, it does not allow for obtaining an image of the financial cash flows that change the financial structure of the company or that change the company's cash. The information related to the cash flows of an entity is useful for the users of the financial statements in the economic decision-making process, because it is a basis for the assessment of the entity's capacity to generate cash and cash equivalents, as well as the usefulness of such cash flows. The company performance analysis based only on indicators calculated with the help of the profit and loss account is often relative and, therefore, it results in the need to determine the entity's capacity to generate cash or cash equivalents. Intermediate management balances are mere intellectual formalizations of potential gains that, in the context of the accrual accounting, create a hypothetical dimension of the company performance. Free cash flows should not be interpreted in a simplistic manner based on their negative or positive value.

JEL classification: G32, M41

Key words: cash flow; cash indicators; performance

1. INTRODUCTION

The cash flow need arises in the context of the limits of the balance sheet and of the profit and loss account in reflecting financial and accounting information.

Although the profit and loss account provides a dynamic image of the activity of a company, it does not allow for obtaining a view in the financial flows that change the financial structure or the cash of a company.

Bernard Colasse¹ differentiates three categories of cash flow:

- cash flows with a direct impact on the company's cash on hand (purchases paid and sales cashed immediately);

¹ Colasse, B., Comptabilité générale, 7 édition, Economica, Paris, 2001

- cash flows with a subsequent impact on the company's cash on hand (purchases and sales on credit);
- cash flows without any impact on the company's cash on hand (e.g., amortisation costs generate value diminishing cash flow).

The information on the cash flows of an entity is useful for the users of the financial statements in the business decision-making process, because it is a basis for the assessment of the entity's capacity to generate cash and cash equivalent, as well as of the usefulness of such cash flows.

The company performance analysis based only the indicators calculated by means of the profit and loss account is often relative and, consequently, there is the need to determine an entity's capacity to generate cash or cash equivalents. Intermediate management balances are mere intellectual formalizations of potential gains, in the context of the accrual accounting, create a hypothetical dimension of the company performance.

The preparation of the cash flow statement is necessary due to at least three reasons:

- the importance of the cash flow as a company management and bankruptcy risk analysis indicator;
- the objective nature of cash flows;
- the adjustment of the cash flow statement to the forecast analysis.

In our country, the information valences of the cash flow statements have not been very well known due to the fact that there were no mandatory requirements for preparing and submitting them.

We all know that in the Continental European countries the long-term financial balance of a business entity was and still is analysed by means of the "working capital" indicator. However, financial globalisation in the in the context of the accounting evolution proves that the *working capital* variation is influenced by the implementation of accounting conventions, and is characterised by a poorer objectivity as compared to the indicators determined based on cash flows. Thus, the cash flow variation is replaced by the cash variation. Cash flow is a partial and transitory result indicator that only takes into account the monetary income and spending, and it does not also take into account the income and spending that are only calculated. Moreover, cash flow links profitability with liquidity. The profitability and the liquidity do not converge in the same direction, taking into account that there are profitable businesses that face cash difficulties and vice versa, less profitable businesses that have sufficient cash. Creditors are more interested in the entity's liquidity and credit worthiness rather than in their profitability.

While performance can be assessed by means of indicators, we cannot say the same thing about measurement of the satisfaction of the main users of financial statements, the shareholders.

2. THE CONTRIBUTION OF CASH INDICATORS TO THE COMPANY ANALYSIS AND MANAGEMENT IN TERMS OF INFORMATION

The cash flow interpretation implies comparing the net profit with net operating cash flows and the latter with dividend payments.

In the case of cash flows, the indicators that reflect cash flows in absolute value are determined:

- the net cash flow from operating activities;
- the net cash flow from investments;
- the net cash flow from financing activities.

In analysing the monetary equilibrium, a number of indicators calculated as ratios² are significant, such as:

- a) the liability coverage ratio:
- is determined as: $\text{cash flows from operations} / (\text{Annuities} + \text{dividends} + \text{investments})$
 - interpretation:
 - a value less than 1 shows that the cash flows from operating activities are insufficient to cover the debts to creditors, shareholders and fixed asset suppliers;
 - a value higher than 1 shows a self-generation of cash from the operating activity that covers the debts to creditors, shareholders, and the payments for the purchase of fixed assets;
- b) term debt repayment rate
- is determined as: $\text{Annuities} / \text{cash flows from operating activities} (\%)$
 - interpretation: a ration less than 1 is favourable
- c) dividend payout ratio
- is determined as: $\text{Dividends} / \text{cash flows from operating activities} (\%)$;
 - interpretation: the more rapid increase of cash flows from operating activities as compared to the dividend growth rate leads to cash surplus to pay the shareholders' expectations.
- d) investment ratio:
- is determined as: $\text{Investments} / \text{cash flows from operating activities} (\%)$
 - interpretation: reflects the share of payments for investments in cash flows from operating activities
- e) total debt repayment capacity rate
- is determined as: $\text{total debts} / \text{cash flows from operating activities}$
 - interpretation: represents the number of years in which it is possible to reimburse the total debts from cash flows from operating activities

The cash flow management must be made from the perspective of the profitability-risk relationship through adequate inventory, granted and received commercial credit, and investment management policies.

The actual dimension of the cash flow exists when all the transactions generate cash flows in the form of receipts or payments. The potential dimension of the cash flow is called operating cash surplus (OCS) deriving from the gross operating surplus according to the formula $\text{OCS} = \text{GOS} - \Delta \text{NFRE}$.

The variation of the working capital need is determined according to the stock variation, the variation of operating receivables and the variation of the operating liabilities.

In our opinion, OCS allows for a pertinent performance assessment, as it is not influenced by the accounting method of depreciating assets or by the option chosen for the stock assessment.

The attributes of this indicator can be summarised as follows in the table below.

Table no. 1. Characteristics of the operating cash surplus (OCS), potential dimension of the cash flow

OCS is a profitability indicator	Due to the fact that it can be used to assess profitability The profitability assessment must be made on average and long
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² Maria Berheci, *Valorificarea raportărilor financiare*, ECECCAR Publishing House, Bucharest, 2010

	term because OCS depends, as the case may be, on the variation of the working capital need.
OCS is a financial equilibrium indicator	It can assess the company's repayment capacity and the bankruptcy risk
OCS is an autonomy and flexibility indicator	The bigger a company is, the more autonomous and flexible it gets. It resorts to loans to a lower extent.
OCS is an indicator of the competitiveness of the various activities	It is used to assess companies' competitiveness through the Boston Consulting Group model.

The Boston Consulting Group model presents the four categories of activities of the company differentiated from the perspective of the consequences on the operating cash surplus.

Table no. 2. The four categories of activities differentiated by Boston Consulting Group model with an impact on the OCS values

Types of activities	Characterisation of the activity from the point of view of the growth rate and of the market share	Consequences on the value of OCS (operating cash surplus)
"Stars"	Strong growth rate	In order to finance high investments medium OCS is needed
	High market share leading to high gross operating surplus	
"cash cows"	Low growth rate	High OCS can be used to finance other activities because the investment rate is slow
	High market share generating high GOS	
"question marks"	Strong growth rate	Since OCS is low: ✓it can cover the working capital variation due to growth: ✓when OCS is negative, loans are used
	Low market rate generating low GOS	
"dogs"	Low growth rate	OCS is low but it does not requires investments
	Low market rate generating low GOS	

The official recognition of a certain level of performance is substantiated in the market value of the securities of the company and shareholders are interested mainly in the increase in the share price.

The notion of cash-flow accounting adjustment is used as result management measure. A very important aspect is that the adjustments are not always available to the manager.

The empirical research revealed that the threshold-based management is significant to explain the result management. When the result of the previous year is achieved, the company will try to diminish its result. This means that the result is managed according to a future planning of the results;

If the manager is also a significant shareholder, then he should be less tempted to manage the result due to opportunistic needs. As company owner, the manager can influence the result in his own way to send a certain signal on the market, which cannot be done by a simple manager due to the shareholders' suspicions of opportunism in what he is concerned.

We will approach the CFROI – Cash Flow Return on Investment indicator below; due to the fact that it is built based on the cash flow theory. In fact, this indicator represents the internal rate of return of the cash flows related to the current investments. Generally, in

order to assess the quality of the investments made, these cash flows must be disclosed in the cost of the invested.

The Cash Flow Return on Investment seems to have the same role as the internal rate of return, by there are differences.

Practitioners know the fact that the value of the company is generated not only by the cash flow return on investment corresponding to the existing assets, but also by the cash flow return on investment corresponding to the future investments. Holt Associates, one of the main promoters of the indicator CFROI, implement a CFROI “depreciation” factor, thus admitting that in time the cash flow return on investment decreases as compared to the real cost of capital. This “depreciation” factor is empirically anticipated, based on the statistical records of the companies distributed based on the values of CFROI recorded in time.

The literature provides several methods to increase the value of a company:

- ✓ increasing the CFROI corresponding to the existing assets, for a certain level of the gross invested capital;

- ✓ decreasing the CFROI decrease speed under the action of the “depreciation factor;

- ✓ decreasing the pace of the CFROI decrease the action of the “depreciation factor.

The relationship between the cash flow return on investment and the value of the company is less intuitive than the relationship between the economic added value and the value of the company.

Company managers may perform activities that can lead to the increase in CFROI, while the value of the company decreases.

Between the cash flow return on investment and the market value of the company there is a certain connection. Generally, companies having a high cash flow return on investment are rewarded with a high value. However, the profitability is not created by the market value itself, but by the changes in the company market value.

Any increase in CRFOI is a positive signal for investors and, in theory, companies with the highest cash flow returns on investment should obtain added profitability.

3. CASH FLOWS IN THE CONTEXT OF THE INTERNATIONAL FINANCIAL REPORTING STANDARDS

Being an integrant part of the financial statements, the cash flow statement supplies information that allows users to assess the changes in the net assets of the entity, its financial structure, including information concerning its liquidity and solvency, as well as the capacity of the entity to influence the value and the time when cash flows arise. According to IAS 7, cash flows include three components.

The cash flows from operating activities are an important part of the cash flow statement, because they show the success or failure of such activities in generating flow sufficient to pay loans, pay dividends and make new investments, without forcing the entity to resort to external financing sources.

The cash flows from investment activities are disclosed separately because they represent expenses made with resources meant to generate income and cash flows in the future.

The cash flows from financing activities provide information about the structure of equity and the liabilities of the entity, i.e. useful data for those who finance the entity.

Cash results from all the flows driven through the operations of the operating cycles and outside the operation (investment operations, financial operations on the capital markets and exceptional operations).

The cash flow generated by the operating activity can be determined both by the direct method, as well as by the indirect method. In our opinion, the direct method is more pertinent because it allows users to set the financial policy in the management of the operating activity.

The indirect method for the calculation of the cash flow is used by many companies, being easier to apply. On the other hand, company managers tend to use the indirect method to assess cash flows because this option does not present the liquidity and solvency of the business entity in a clear manner and consequently certain information can be hidden or concealed.

In Romania, this cash flow statement becomes mandatory through OMPF 94/2001 on the Accounting regulations harmonised with Directive IV and with the International Accounting Standards but only for the companies included in the harmonization programme, specifying that the company in question could choose the method of reporting operating cash flows.

OMPF 3055/2009 for the approval of the accounting regulations in compliance with the European Directives specifies that only big companies are required to prepare the cash flow statement. Unlike OMPF 1752/2005 (which presents only one cash flow statement template, based on the direct method), OMPF 3055/2009 presents cash flow statement templates based both on the direct method and on the indirect method (Table no. 3).

Based on the data supplied by the cash flow, analysts can assess the free cash flows that are used in the calculation of the company value. Free cash flows represent the cash generated by operating activities, less capital expenditure required to keep the current level of the activities. IFRS require that the costs necessary to keep the current activity level be presented separately from those incurred for the expansion or improvement of the activity.

Free cash flows should not be interpreted in a simplistic manner based on their negative or positive value. Such Free cash flows greatly depend on the stage of the life cycle of the company's field of activity.

Table no. 3. Methods recommended by OMPF 3055/2009 for the cash flow assessment

Direct method	Indirect method
Cash flows from operating activities (I)	Cash flows from operating activities (I)
+receipts from the sale of goods and service provision	± net result
+ receipts from royalties, fees, commissions and other incomes	+ costs of depreciation and provisions
- payments made by goods suppliers and service providers	- incomes from provisions
- payments made to and on behalf of the employees	± result from the transfer of fixed assets
+/- the receipts and payments of an insurance entity for premiums and damages, annuities and other benefits generated by insurance policies	± result from the transfer of short-term financial investments
- interests paid	+interest costs
- income tax paid	- income from interests and dividends
+ proceeds from the insurance against	- subsidies for investments transferred to incomes
	±stock variation
	±variation of receivables
	±variation of the operating liabilities
	±variation of deferred incomes

earthquakes	
Cash flows from investment activities (II)	Cash flows from investment activities (II)
- payments for the purchase of intangible assets + proceeds from the sale of intangible and tangible assets - payments for the purchase of equity instruments of other companies +proceeds from the sale of equity instruments of other companies - advance payments and loans to other parties +cash proceeds from the repayment of advance payments and loans by other parties - payments related to futures, forward, option and swap contracts +proceeds from futures, forward, option and swap contracts	- payments for the purchase of intangible and tangible assets + proceeds from the sale of intangible and tangible assets - payments for the purchase of equity and debt instruments of other companies +proceeds from the sale of equity and debt instruments of other companies - advance payments and loans to other parties + cash proceeds from the repayment of advance payments and loans by other parties - payments related to futures, forward, option and swap contracts +proceeds from futures, forward, option and swap contracts
Cash flows from financing activities (III)	Cash flows from financing activities (III)
+proceeds from the issue of shares and equity instruments - payments to shareholders for the repurchase of own shares +proceeds from the issue of bonds, credits, mortgages and other loans - repayment of borrowed amounts - payments by the tenant for the decrease of the financial lease liabilities	+proceeds from issue of shares and equity instruments - payments to shareholders for the repurchase of own shares + proceeds from the issue of bonds, credits, mortgages and other loans - repayment of borrowed amounts - payments by the tenant for the decrease of the financial lease liabilities
Net increase in the total cash and cash equivalents (I+II+III)	Net increase in the total cash and cash equivalents (I+II+III)
Cash and cash equivalents at the beginning of the accounting period	Cash and cash equivalents at the beginning of the accounting period
Cash and cash equivalents at the end of the accounting period	Cash and cash equivalents at the end of the accounting period

4. CONCLUSIONS

The main uses of the cash flow statement can be summarised as follows:

- ✓ it supplies information on the proceeds from and the payments of financial means arising during an accounting period at the level of a company;
- ✓ it supplies information on the operating, investment and financing activities, in which a company is involved;
- ✓ it supplies information to investors and creditors on the liquidity ration of a company and its capacity to generate positive cash flow;
- ✓ it allows users to reconcile the difference between net profit and the net cash flows generated by the operating activity of a company.

The cash flow is often viewed as the most objective component of the financial statements. In fact, we can say without risking to make a mistake that it is possible to embellish cash flow in the context of the legal flexibility allowed in the calculation of this indicator. Basically, some investments or financing items are reclassified to operational cash to report a higher operating cash flow, despite the fact that the real cash flow, i.e. the cash that could be used, as free cash flow, does not change.

Most modern indicators used to quantify performance such as the Cash Flow

Return on Investment – CFROI, due to the methods of retreating accounting information and to the complexity of the approach, risk to distort their role of pertinently measuring the performance of a company in the conditions of an unstable economic environment. On the other hand, this indicator does not take into account the competition among companies (assumes equal costs of the capital used by various companies) and do not differentiate the operating activity from the financial one.

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