

# THE ADVANTAGES OF CASH FLOW AS A COMPANY ANALYSIS AND EVALUATION INDICATOR

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## **Abstract:**

*The purpose of the financial analysis of the company is to highlight the impact of the operating, investment and financing decisions on the activities and results of the company. The decisions of the company's management have an impact not only on the return of the year, they also generate significant changes in the assets and liabilities in the balance sheet of the company, especially in the net quick assets (a notion that includes available money, clients' debts, raw material, materials and finished products inventory, and short-term liabilities, whether to the suppliers or to the banks).*

**Key words:** cash flow situation, existing cash and cash equivalents, investment policy

**JEL classification:** G00

For the evaluating the company, the cash flow concept requires certain adjustments in order to highlight the capacity of the company to generate available cash flow for its shareholders and creditors, with the purpose of recovering the capital invested into the business and remunerating this capital (through dividends due to shareholders and interests payable to creditors)<sup>1</sup>. The determination of the available cash flow of the company starts from accumulations of money generated from administrative operations dedicated to the remuneration of investors. Thus, a management cash flow is determined se ( $CF_{gest}$ ), using the following calculation formula:

$$CF_{gest} = PN + AMO + DOB$$

In our opinion, since the after-tax profit of the company already includes the tax savings generated by the deductibility of interest expenses (DOB), it is necessary to integrate the net interest expenses into the management cash flow by this tax saving, as follows:

$$CF_{gest} = PN + AMO + DOB \cdot (1 - t),$$

where  $t$  is the profit tax percentage rate.

In the opinion of some authors<sup>2</sup>, as a result of the main role played by the operating activities within the management activity of the company, the evaluation of the management cash flow should be made starting from the after-tax operating profit of the company and calculated as the difference between EBIT and the profit tax:

$$CF_{gest} = EBIT \cdot (1 - t) + AMO$$

As we have mentioned hereinbefore, the available/free cash flow represents the cash surplus (or, as the case may be, the deficit) left in order to be distributed to investors when the company has made all the investments in the fixed and circulating assets required in order to support its operations. These investments represent the economic growth of the company, calculated as the total additional investments in fixed and circulating assets made during the fiscal year:

$$CEc = \Delta IMO + \Delta NFR$$

<sup>1</sup> In the specialized Anglo-Saxon literature, this concept is known as "free cash flow".

<sup>2</sup> Brigham and Ehrhardt, Financial management: theory and practice, South-Western College Pub, 2002

where:

- $CEc$  = the economic growth of the company;
- $\Delta IMO$  = the annual variation of the fixed assets, calculated as the difference between the value of the fixed assets at the end of the financial year and the value of the fixed assets from the beginning of the financial year, to which the depreciation corresponding to the period is added;
- $\Delta NFR$  = the annual variation of the working capital need.

Taking into account the above-mentioned aspects, we can write the following formula for the calculation of the available cash flow (CFD):

$$CFD = CF_{gest} - CEc$$

At a strictly accounting level, the assessment of the company performance is made by using the net return of the financial year. Although this accounting result is important, it does not justify the increase in the value of the company. The main role in the assessment of the value of a company is played by its capacity to generate consistent available cash flows, and the only method by which the company management can increase its value is to increase the available cash flow.

Brigham and Ehrhardt highlight four possible uses of the available cash flows, as follows:

1. to pay interest expenses;
2. to pay off part of the company debts;
3. to pay dividends;
4. to repurchase stock (if the social capital is decreased).

Companies should never use their available/free cash flows to make investments in operating assets because, by definition, CFD (*FCF - free cash flows*) include all the operating (fixed and circulating) asset costs required for the support of the activities of the company. Unfortunately, financial practice shows that there are companies with high free cash flows which tend to make investments that do not add value, such as buying other companies at unreasonably high prices. This interesting idea, referred to in the specialized literature as the “free cash flow hypothesis” and emphasized for the first time in Jensen’s studies (1986), states that high values of the free cash flows may lead to waste, if the managers of the companies do not act in the shareholders’ interest. This free cash flow waste is also referred to as “management cost” because, the company management is basically mandated by the shareholders to maximize the value of the property they own.

The free cash flow hypothesis has some subtle implications concerning the structure of the capital of the company. Due to the fact that dividends represent cash outflows, they decrease the free cash flow and, according to the free cash flow hypothesis, an increase in dividends would be in the shareholders’ interest not only from the point of view the profit they make, but also due to the fact that the managers’ opportunity to waste financial resources they manage is thus decreased. The interest paid to creditors and the reimbursed installments also represent cash outflows decreasing the free cash flow, which should also decrease the company managers’ tendency to waste resources, because the company is subjected to the bankruptcy risk if it cannot repay its debts. Consequently, indebtedness reduce managers’ opportunities to use the available resources in an inefficient manner, which creates the conditions required for the future growth of the company’s value.

A positive value of the free cash flow of the company corresponds to an ideal situation in which the company manages to support, at the expense of its management operations, its own economic growth and, at the same time, to generate enough cash surplus for the remuneration of the shareholders and creditors and, at the same time, to reimburse part of the contracted debts. If the free cash flow is negativ, in addition to the fact that there is no cash to be distributed to investors, these investors should supply

additional capital to the company if they want to keep their business afloat. So the negative CFD is associated to a capital deficit.

If the CFD is negative a careful analysis of the causes that led to this state is required, though this situation should not be a priori deemed as being negative. The free cash flow can be negative in the case of companies with a sustainable growth making massive investments in production capacities and in working capital. If, for these companies, the operating return is positive, a negative CFD is not an alarm signal. Things change in the operating activity of the company generates loss, because it is quite likely that this represents a sign of disfunctions at the level of the production activity and at the commercial level of the company. Moreover, a negative value of the free cash flow is also worrying if the operating cycle shows unreasonable increases in the financing needs.

The free cash flow can also be analysed according to its *purpose*, which implies separating it on two levels: the relation with the shareholders and the relation with the creditors of the company. From this perspective, CFD is made of free cash flow for shareholders ( $CFD_{act}$ ) and free cash flow for creditors ( $CFD_{cred}$ ):

$$CFD = CFD_{act} + CFD_{cred}$$

From the strict perspective of the shareholders, the free cash flow is the result of the interaction among the collected dividends (cash inflow), reimbursements of capital given to the company for use (cash inflow) and the additional capital contributions. Consequently, the formula of  $CFD_{act}$  is as follows:

$$CFD_{act} = DIV - \Delta CPR$$

A situation in which  $CFD_{act}$  is positive corresponds to dividends collected by the shareholders the value of which is higher as compared to the additional funds contributed by them during the respective financial year. A negative value of  $CFD_{act}$  indicates the opposite situation.

Some authors<sup>3</sup> state that the value of the free cash flow for the shareholders should be estimated starting from the after-tax profit stated by the company, according to the formula:

$$CFD_{act} = PN - \Delta CPR$$

A possible motivation of this definition given to  $CFD_{act}$  is based on the use of after-tax profit as an element which increases the equity capital of the company and therefore the value owned by the shareholders. Although from the after-tax profit the shareholders only collect the distributed dividends, the after-tax profit has a substantial contribution to the capacity of the company to finance its own activity by increasing its own funds, thus creating the conditions required for a financial autonomy that can only have a positive impact on the company: the interest expenses will be diminished, the company will become more profitable and will thus benefit from easy access to external financing in the future (if the case may be). All these aspects have a positive effect on the company's market value, due to which, besides the direct cash inflow represented by dividends, the shareholders also benefit from a potential cash inflow generated by the increase in the stock exchange value of the shares they own.

The free cash flow for creditors takes into account the interests they collect from the company and the annual variation of the company's debts:

$$CFD_{cred} = DOB - \Delta DAT$$

A positive value of the  $CFD_{cred}$  indicator may be generated if, for example, the company pays the interests due to its creditors and pays back the contracted debts, using a small amount of borrowed capital. The free cash flow for creditors may have negative

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<sup>3</sup> For example, Vintilă (2005), page 161.

values due to a financing policy the purpose of which is to increase the indebtedness (in order to benefit from the financial leverage, for example).

For a relevant analysis of the company's activity, it is necessary to study the information supplied by the balance sheet and by the profit and loss account together with the information included in the company's cash flow statement.

The main advantages provided to the accounting information users by the analysis of the cash flow statement are the following:

1. Supplying an overview of the company's financing structure (including its liquidity and solvability), as well as of the company's capacity to influence the size of cash flows and to ensure their synchronization so that it may adjust to the changing conditions of the environment in which the company performs its activity.

The cash flow statement of the company provides important information concerning the cash flows from the operating, investment and financing activities of the company, i.e. information that is not available in the the balance sheet and in the profit and loss account, or is not readily accessible in these sheets. At the same time, IAS 7 recommends that some additional elements be made public (such as those related to the lending facilities of the company which have not yet been used by the company), or it is mandatory that such elements be published (like, for example, the cash owned by the company that is not available for use); corroborated with the company's cash flow statement, these elements contain information that is very valuable for the users of the financial statements. Based on the above-mentioned information, they can assess the financial status of the company and its likely future results, much more precisely than by analysing the balance sheet and the profit and loss account.

2. Supplying financial statement users with relevant information concerning the changes in the assets debts, and equity capital of the company.

According to IAS 1 "Presentation of Financial Statements", the company's financial statement reflects the book value of the assets, liabilities and equity capital both at the end of the current financial year, as well as at the end of the previous one. If the company's cash flow statement were not part of the financial statements, the users of these statements would not have a clear image concerning the reasons for the balance sheet changes from one year to the next one, or would have to approximate these changes themselves. Such an approach of the problem would only lead to the estimation of the increase or decrease in the value of the elements of the balance sheet which, in the absence of other information, should only be taken into account in relation to the corresponding elements from the profit and loss statement (for example, the annual variation of the clients' debts could be used to estimate the volume of goods sales that were collected, out of the total sales). However, the company can perform complex operations (such as, for example the acquisition of another entity, together with its debts, which could generate the artificial increase in the company's debts), which would not be easily understandable and would lead to erroneous conclusions regarding the data in the balance sheet and profit and loss statement if the company did not state the situation of its cash flows.

3. Providing the comparability of operating results of various companies by eliminating the effects of using various methods and accounting treatments for the same events and transactions.

Ever since the 1960s and the 1970s there was the problem of "standardizing" accounting, which was manifested against the background of the usage of different accounting methods by different companies (for example in relation to the fixed assets depreciation), which made the information in the companies' financial statements incomparable. This problem was solved by legally compelling companies to publish the cash flow statement, thus passing to a stage called "*cash flow accounting*".

4. Represents a reliable indicator of the size, synchronization and certitude of the future cash flows. Moreover, if the financial department of a company has implemented a system for the estimation of future cash flows, the cash flow statement can be used for the evaluation of the accuracy of the estimation model (by comparing the values forecast in the past with those actually achieved ).

The after-tax profit is different as compared to the cash flow and the closer the cash flow of the financial year to the after-tax profit stated by the company, the better the investors' perception of the quality of a company's profits. A company can choose among several main accounting methods and, many times, it expresses its preference for the treatments that maximize the stated results. However, investors treat such face lift of the company's profit with reticence and do not attribute a special "quality" to such profit.

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