

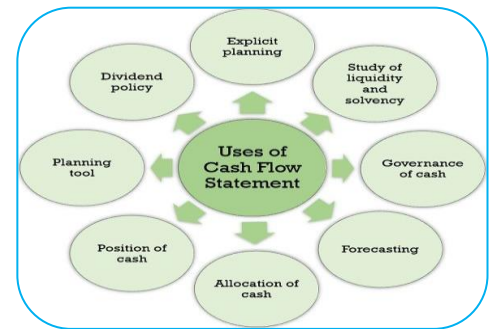


A STUDY OF CASH FLOW STATEMENT IMPORTANCE FOR BUSINESSES

Shiv Narayan Chaudhary
Lecturer , M.M.A.M, Campus, Biratnagar,
Tribhuvan University, Nepal.

ABSTRACT:-

One financial element that facilitates effective running of business enterprises is cash. It is generally believed that cash is the lifeblood of a company. This implies that continuous generation of cash is an essential, though not sufficient, reason for a firm's continuing in business as a strongly going concern. In practical terms, receipts (inflows) and payments (outflows) of cash make it possible for economic units to effectively conduct business transactions. Without cash flow statements, lenders have an incomplete picture of the business simply because accounting entries alone do not reveal both the degree to which historical and future cash flows cover debt service and borrowers' chances for survival. Credit-worthy low-volatile operating cash flows point to reduced default probabilities. On the other hand, lenders view weak, unreliable operating cash flow and increasing, elevated default probabilities as two peas in the same pod.



KEY WORDS:- Cash Flow Statement, Cash Flow Management, Financial Stability, Strategic Decision Making.

INTRODUCTION :-

The notion of cash flow depicts the necessity of cash in promptly meeting financial obligations that arise from normal transactional exchanges in business. Therefore, cash flow is instrumental in satisfying such critical financial obligations as settlement of creditors, repayment of debt, payment of employees' salaries, and so on. From lending perspective, the flow of cash is perhaps the single most important element on which banks hinge hope for prompt loan repayment. When cash flows of borrowers are weak, banks that lend money to them become exposed to a high risk of default. The converse is also true—loan repayment ability of borrowers tends to be enhanced with strong cash flows. In most cases, this explains why banks rely heavily, if not entirely, on cash flows in making critical lending decisions. The obsession of banks with cash flows has given rise to what is now termed cash flow lending. This phrase denotes the practical reliance of banks on cash flows of borrowers in making critical lending decisions.

Cash flow contrasts from, and is for a bank more important than, profit in any consideration of financial capacity of borrowers to repay loans. Profit might be declining whereas cash flows remain strong. For example, a company can sustain a good cash flow position in a given financial year by selling off certain equipment, or other assets, even though sales are insufficient. Cash realized from disposal of the assets offsets the impact of insufficient cash sales during the period. There could also be another scenario in which a company always replaces or increases stock levels. In this case, the company might not be in a position to preserve sufficient cash. On the contrary, a company that does not replenish

stocks as fast as it uses them up will conserve cash. There is yet another important consideration that establishes the preeminence of cash flow over profit in making lending decisions. Whereas a company can easily manipulate its profit figures, it cannot maneuver the true cash it generates from operations.

CASH IS KING

Profit figures are easier to manipulate because they include non-cash line items such as depreciation expenses or goodwill write-offs. Under generally accepted accounting principles (GAAP) businesses can use noncash expenses such as depreciation and amortization to offset large capital expenditures. Cash flow statements, on the other hand, provide a more straightforward report of the cash available. In other words, a company can appear profitable “on paper” but not have enough actual cash to replenish its inventory or pay its immediate operating expenses such as lease and utilities. If a company cannot purchase new inventory, it will slowly become unable to generate new sales. If a company cannot afford its operating expenses, it will eventually go out of commission. Either way, “Cash is King” in keeping a business alive.

CASH FLOW ANALYSIS BASICS

Cash flow analysis first requires that a company generate cash statements (opens in new tab) about operating cash flow, investing cash flow and financing cash flow.

- Cash from **operating activities** represents cash received from customers less the amount spent on operating expenses. In this bucket are annual, recurring expenses such as salaries, utilities, supplies and rent.
- **Investing activities** reflect funds spent on fixed assets and financial instruments. These are long-term, or capital investments, and include property, assets in a plant or the purchase of stock or securities of another company.
- **Financing cash flow** is funding that comes from a company’s owners, investors and creditors. It is classified as debt, equity and dividend transactions on the cash flow statement.

PREPARING A CASH FLOW STATEMENT

Let’s first look at preparing the operating cash flow statement. The line items that are factored into the company’s net income and are included on the company’s operating cash flow statement include but are not limited to:

- Cash received from sales of goods or services
- The purchase of inventory or supplies
- Employees’ wages and cash bonuses
- Payments to contractors
- Utility bills, rent or lease payments
- Interest paid on loans and other long-term debt and interest received on loans
- Fines or cash settlements from lawsuits

There are two common methods used to calculate and prepare the operating activities section of cash flow statements.

The Cash Flow Statement **Direct Method** takes all cash collections from operating activities and subtracts all of the cash disbursements from the operating activities to get the net income.

The Cash Flow Statement **Indirect Method** starts with net income and adds or deducts from that amount for non-cash revenue and expense items.

The next component of a cash flow statement is investing cash flow. That bottom line is calculated by adding the money received from the sale of assets, paying back loans or selling stock and subtracting money spent to buy assets, stock or loans outstanding.

Finally, financing cash flow is the money moving between a company and its owners, investors and creditors.

Importance of Cash Flow Statements for Businesses

Cash flow is crucial for businesses due to several key reasons. Here're some of them:

Cash flow management

Efficient cash flow management ensures that there's enough liquidity to cover expenses, invest in growth opportunities, and withstand economic downturns. It enables businesses to meet their obligations promptly and take advantage of favorable circumstances.

Financial Stability

Positive cash flow acts as a safety net against unanticipated costs and variations in revenue, which promotes financial stability. It enables companies to get through hard times without having to borrow money or sell assets when navigating through a crisis.

Strategic Decision Making

Decision-makers can undertake strategic objectives like expansion, R&D, or acquisitions with the support of a robust cash flow. It offers the freedom to fund initiatives that improve long-term growth potential.

Debt management

Maintaining positive cash flow reduces reliance on debt financing, lowering interest expenses and debt service obligations. It enables entities to manage their debt levels prudently and avoid excessive financial leverage.

Investor confidence

Consistent positive cash flow signals financial strength and operational efficiency, enhancing investor confidence and potentially lowering the cost of capital. It reflects a company's ability to generate sustainable returns and distribute dividends to shareholders.

How Cash Flow Is Calculated?

Calculating cash flow includes analyzing inflows and outflows of cash over a specific period of time. Here's a basic formula:

Cash Flow = Cash Inflows - Cash Outflows

There are two common methods used to calculate the operating activities section of the cash flow statement: the direct method and the indirect method.

1. Cash flow statement direct method

The direct approach, which is based on transactional data that had a direct impact on cash during the period, is used to generate the operating activities component of the cash flow statement. This is how the calculations are done:

Cash Collections from Operating Activities: Add up all of the cash received over the time period, including interest, dividends, and cash from customers.

Cash Disbursements from Operating Activities: deduct all cash payments made to employees, tax authorities, suppliers, interest providers, and other operating expenses throughout the period.

When using the direct technique, cash disbursements from cash receipts are subtracted to determine net cash flow from operational operations.

2. Cash flow statement indirect method

The indirect method relies on accrual accounting principles, where revenues and expenses are recorded when earned or incurred, regardless of when cash is actually received or paid. Here's how it's calculated:

Start with Net Income

Begin with the amount of net income obtained from the income statement.

Adjustments for Non-Cash Expenses

Find and subtract any non-cash costs—like amortization and depreciation—that are shown on the income statement. These costs are included in the income statement but do not require cash withdrawals.

Adjustments for Changes in Working Capital

Make adjustments for modifications to working capital accounts (such as accounts payable and receivable) that have an impact on cash flow. For instance, an increase in accounts receivable deducts from since it signifies cash obligated to sales but not yet collected.

Other Adjustments:

Account for any other non-operating or non-cash items affecting net income, such as gains or losses on asset sales or changes in deferred taxes. These adjustments are crucial for providing a clear picture of a company's cash flow situation.

6 Tips For Managing Cash Flow effectively.

1. Monitor receivables and payables

Monitor accounts receivable closely to make sure customers pay on schedule. To reduce delays, establish transparent billing and collection procedures. Likewise, work out advantageous terms of payment with suppliers to maximize cash flow and efficiently handle accounts payable.

2. Control expenses

Examine your expenditures on a regular basis to find areas where you may cut or maximize expenses. Search for ways to reduce inefficient spending, renegotiate vendor contracts, or streamline operations. Controlling expenses helps preserve cash and improve overall financial health.

3. Maintain adequate reserves

Establish and keep sufficient financial reserves to handle unforeseen costs or revenue shortages. The goal should be to have sufficient cash on hand to keep things running for a few months without needing outside funding. Having a cash cushion lessens the need for debt and acts as a safety net in trying times.

4. Optimize inventory management

Maintain a healthy balance between inventory levels to prevent stock outs or overstocking, which could waste cash or result in lower sales. Use inventory management systems to keep tabs on stock levels, sales patterns, and out-of-date or slow-moving items. Optimizing inventory turnover allows you to free up funds for other demands of your company.

5. Explore financing options

Explore various financing options, such as lines of credit, business loans, or invoice financing, to bridge short-term cash gaps or fund strategic initiatives. Compare terms and interest rates from different lenders to find the most suitable financing solution for your needs. However, use debt judiciously and ensure that repayment terms align with your cash flow projections.

6. Forecast cash flow

Make regular cash flow forecasts by estimating your future earnings and expenses. Be prepared for seasonal variations, significant expenses, or collections delays in receivables. This enables you to anticipate possible cash shortages and take proactive steps to minimize them.

Limitations of Cash Flow Statements

Doesn't reflect accrual basis accounting

The cash flow statement does not take accrual-based transactions into account; it only concentrates on cash transactions. This implies that non-cash components like amortization and depreciation are not included, which could result in an inaccurate representation of a company's financial performance.

Subject to manipulation

The cash flow statement is susceptible to manipulation and dishonest accounting techniques, just like any other financial statement. Businesses may use strategies to time cash transactions or payments, for example, in order to inflate or manipulate cash flows. This might cause the genuine financial position to be distorted.

Limited predictive ability

Although the cash flow statement sheds light on previous cash flows, it is not very good at projecting future cash flows. Future cash flows may be affected differently from past trends by shifts in market dynamics, company strategies, or economic conditions.

Ignores non-cash investing and financing activities

The cash flow statement may not include major non-cash financing and investing operations because it primarily focuses on cash flows from operating activities. A company's financial health may be affected over time by the issuance of bonds or stock, for instance, even though these actions may not have an immediate effect on cash flows.

No standardization across industries

It can be difficult to compare cash flow statements across sectors since different industries may have different capital expenditure requirements and cash flow characteristics. An industry's definition of a good cash flow level may differ from one another.

Doesn't consider timing differences

Timing discrepancies between cash inflows and withdrawals are not taken into consideration by the cash flow statement. For instance, a business may accept cash from clients but put off paying suppliers, which would cause its cash reserves to rise momentarily. The understanding of real cash flows may be distorted as a result.

Doesn't reflect non-recurring items

Non-recurring or unusual items that might have a major influence on a company's financial performance in a particular period may not be sufficiently captured in cash flow statements. These items might include restructuring, asset impairments, or one-time profits or losses.

Understanding these limitations is essential for interpreting the cash flow statement accurately and supplementing it with additional financial analysis to gain a comprehensive understanding of a company's financial position and performance.

CONCLUSION

In conclusion, even though the cash flow statement is an important tool for evaluating the financial health of a business, it's critical to understand its limits. We can uncover a more

comprehensive knowledge of a company's genuine financial situation by recognizing its limits and adding in-depth analysis to complement its observations.

In the world of finance, after all, it's not just about the numbers; it's also about the narrative they convey, the insights they provide, and the choices they motivate. As we move toward greater financial understanding and success, let us take notice of these lessons and approach the complexity of financial analysis with curiosity and prudence.

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