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Revisiting the Format of Cash Flow Statement – An Essentiality

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Abstract

Financial Decisions are taken on the availability of cash, i.e.., inflow and outflow of cash. Cash flow statement is a depiction of inflow and outflow of cash and by classifying these cash flows in three activities operating, financing, and investing activities. The paper provides various suggestions to improve the format of the cash flow statement. It highlights the importance of having common-size cash flows statement based on as a percentage of sales revenue or total assets basis for period of 5 to 7 years. The other main suggestion is to make direct method mandatory for finding out cash flows from operating activities. Paper emphasizes the incorporation various cash ratios in the format of cash flow statement. The retail/small investors (whose participation has increased in the capital market) will get better reliable, precise, useful, and meaningful information from the revised cash flow statement for taking investment decisions for investing in the company. Hence, it has become an essentiality to revisit the existing format.

Key Words: Format of Cash Flow Statement, Cash Ratios, Retail or Small Investor

Introduction

The objective of financial statements is to provide information about the financial position, financial performance, and cash flows. Financial statements also show the result of management's utilization of resources. To meet the objective, financial statements provide information about an undertaking's assets, liabilities, equity income expense, gain and losses, changes in equity cash flows. Essentially, financial statements are prepared for the purpose of external reporting as well as internal reporting. The external reporting refers to delivering information to the external users for e.g., creditors, shareholders, tax authorities, consumers, prospective investors, and all these can be grouped together as stakeholders. These stakeholders require information for decision-making. Information is not just required by stakeholders but also by the employees and management of the company for the internal consumption (internal reporting) for decision-making.

The required financial statements comprise: 1. A balance sheet 2. An income statement 3. Statement of changes in equity 4. Cash flow statement 5. Notes comprising a summery of significant accounting policies, and other explanatory notes. An undertaking prepares it financial statements, except for cash flow information using accrual basis of accounting. The cash flow statement is prepared on cash receipt (inflow) and cash payment (outflow).

The above-mentioned users can be grouped in two categories as large investors (both institutional and individuals) and small investors. While large investors have clout over undertakings and can have access of information they desire for decision-making, small investors do not have such advantage and generally are deprived of the significant information. Large investors can also afford to have professional and technical analysts, but small investors just depend on the publicly available information. With the advent of digitalization and fast changes in the information technology, a new category of small investors has grown in the last two decades. Millions of young Indians have taken to stock trading during the pandemic, raising hopes that the appetite for equities in the world's second-most-populated nation is finally growing. Active investor accounts rose by a record 10.4 million in 2020, according to the data from the country's two main depositories. Retail ownership in more than 1,500 companies listed on the National Stock Exchange of India jumped to 9 per cent in the third quarter of 2020, the highest since March 2018. As evident from the mentioned lines, small and retail investors are now a big source of capital investment, especially in India. Channelizing this savings into corporate investment is vital for economic growth of developing countries like India. And to create confidence in these investors, it is paramount to provide precise, concise, relevant, reliable, and ready to use information.

Why this paper?

The objective of this paper is to suggest improvements in the format of cash flow statement making it more convenient and useful to investors, which would ultimately increase the utility of cash flow statement. Various international accounting bodies have come out with the format of cash flow statement with minor modifications based on customization etc. The format, which, we suggest can also be of immense use to improve the format of Cash flow statement issued by these accounting bodies.

Outline of the paper

The paper presents 1. a brief history of the evolution of Statement of cash flows, 2. its format, and 3. suggestions to incorporate cash flow-based ratios along with other constructive suggestions.

Evolution of cash flow statement

In 1961, The American Institute of Certified Public Accountants, issued the Accounting Research Study No 2, "Cash flow analysis and the fund statement" which recommended that an audited funds statement be included in corporate annual report.

In 1962, the Accounting Principles Board of the American Institute of Certified Public Accountants, in its Opinion No. 3, "The statement of Sources and Application of Funds", came out with standardized fund statement and recommended for changing its name to the Statement of Source and Application of funds. It also recommended that its inclusion in the annual report of the companies as a supplementary information.

In 1970, the Securities and Exchange Commission issued Accounting Series Release (ASR) No 117. Accordingly, Inclusion of fund statement in the annual 10-K filings was made mandatory for the companies registered with Securities and Exchange Commission.

In 1971, The Accounting Principles Board issued Opinion No. 19, Reporting Changes in Financial Position. It recommended changing the title of the statement to "Statement of Changes in Financial Position" (SCFP). It also made it mandatory for inclusion of audited Statement of Changes in financial position (working capital basis) in corporate annual report of the companies.

Number of questions were raised about the usefulness of Statement of Changes in Financial position (working Capital Basis). In 1975, W.T.Grant Company became bankrupt because of its inability to generate ample cash from it operating activities. An SCFP could not answer the Grant's slowly growing liquidity crisis. The pressure was mounting to amend the SCFP.

In 1981, Financial Accounting Standards Board issued the "Statement of Financial accounting concept (SFAC) No. 5, "Recognition and Measurement in Financial Statement of Business Enterprises". Financial Accounting Standards Board (FASB) stated that a full set of financial statements for the period should show cash flows during the period.

In 1985, FASB issued (SFAS) No. 95, "The statement of Cash flows" (SCF), mandating the inclusion of an audited SCF in the corporate annual reports which became effective with the fiscal year ending July 1988. Presently, the SCF is prepared on "Cash and Cash equivalent basis rather than on working capital basis.

International Accounting Standards Board (IASB) had also issued accounting standard on cash flow statement. Some countries have adopted/adapted this accounting standard. India, following the principles of harmonization and convergence of accounting policies, adopted this accounting standard subject to some changes in it.

Let us discuss very briefly, the evolution of cash flow statement in India. Initially, it was Fund flow statement and then SCFP Working capital basis, now it is called Statement of cash flow (cash and cash equivalent basis) classifying the activities in three parts as operating activities, investing activities and financing activities. Earlier, it was not mandatory, but now it is statutorily required and considered as a part of the financial statements. Presently, Ind AS 3 (Statement of cash flows) is complied with by the companies in India prepared on cash and cash equivalent basis.

Format of Cash Flow Statement

Ind AS 3 Classifies its presentation in three categories 1. operating activities, 2. investing activities, and 3. financing activities and column 2 & 3 reveals the figures of current and previous years, which is shown below:

Column 1	Column 2 Amount (Current Year)	Column 3 Amount (Previous Year)	Column 4 % Of Total Sales Revenue	Column 5 % Of Total Assets
Cash flows from operating activities: Cash inflows: List of items related with cash inflows Cash outflows: List of items related with cash out flows Net cash flow from operating activities **Cash flows from investing activities:** Cash inflows: List of items related with cash inflows Cash outflows: List of items related with cash out flows Net cash flow from investing activities **Cash flows from financing activities:** Cash inflows: List of items related with cash inflows Cash outflows: List of items related with cash out flows Net cash flow from financing activities				

Listed below is the number of suggestions for improvisation of format:

1. We suggest improvising this format by adding either of the two columns or both (Column 4,5) Percentage-wise figures should be shown either based on the total sales revenue or total assets or both. It will be a common-size cash flow statement on percentage basis, based on total sales revenue or on total asset or both. Having added these columns, will generate additional information for investment decisions. Cash flow statement should not be just prepared for two years, it should be prepared for 5 or 7 years. The ratios based on this common size statement can present a direction or trend, which could be a guide in analysis of investment decisions.

2. Direct and indirect method – Presently Net cash flows from operating activities is prepared based on indirect method. However, Cash flow statement also recommends the use of direct method. According to us, Direct Method should be made mandatory to compute net cash flows from operating activities. When Direct method is used to compute, it reveals a lot more meaningful and useful information than that it is prepared based on indirect method.

3. The cash flow ratios should be incorporated in the cash flow statement making it statutory. Cash ratios can be used for prediction of financial distress in the companies. Cash ratios provide the useful and meaningful information in addition to the information generated by conventional ratios, which are based accrual-based accounting. This is evident from the various research studies (refer various articles in the references).

We are providing list of cash ratios that can be incorporated in the cash flow statement along with the formula for calculating them. These ratios have been categorized under the head 1. Activities relationship ratios (based on operating, investing, and financing activities in cash flow statement) 2. Performance/Profitability ratios 3. Turnover ratios 4. Long-term and short-term solvency ratios/Coverage ratios.

CFOPA represents Cash flow from operating activities in various formula.

Activities relationship ratios

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

Performance/Profitability ratios

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

Turnover ratios

8. Working capital cash flow ratio (CFOPA/working capital) – It measures the rotation of working capital with respect to cash from operation. Effective use of working capital is measured. Higher the ratio, better it is.
9. Inventory cash flow ratio – (CFOPA/Inventory) -It measures the rotation of inventory with respect to cash flow from operation. Higher the ratio, better it is.
10. Capital expenditure ratio – (CFOPA / (CFOPA-Capital expenditure) - It Measures Availability of cash for capital expenditure. Higher the ratio, better it is.

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

11. Debt coverage ratio (CFOPA/Total debt) – It measures financial leverage. Higher the ratio, better it is for the company. Debt is being paid by the cash generated by operating activities.
12. Reinvestment Coverage ratio (CFOPA/Cash paid to purchasing/acquiring assets with operating cash flows) – It measures ability to purchase assets with operating cash flows. Higher the ratio, better it is.
13. Interest coverage ratio (CFOPA/interest paid) - It measures ability to meet interest obligations. Higher the ratio, better it is.
14. Debt Payment ratio (CFOPA/Cash paid for long-term debt repayment) – It measures to pay long-term debt with operating cash flows.
15. Interest and financing ratio (CFOPA/cash outflows for investing and financing activities) – It measures ability to purchase/acquire assets, pay debts and make distributions to owners. Higher the ratio, better it is.
16. Current ratio (CFOPA/current liability) – It measures the ability to pay current liability out of Cash flow from operating activities. Higher the ratio, better it is.

The list given above is not the exhaustive. Other ratios can be framed by picking up any two figures, but it should generate the meaningful and useful information.

4. Being ratio is the relationship of two quantitative variable i.e., numerator and denominator, both should be precisely defined, what is included in these two variables leaving no doubt of even dual interpretation to achieve comparability for financial analysis. The figures must be verified by the auditors of the company to bring about reliability.

5. Graphical presentation of each ratio should be portrayed highlighting in one top corner of the graph whether higher the ratio, better it is or vice versa. This will help the small or retail investors to extract relevant and meaningful information at a glance.

6. Identifying Cash ratios depend upon the sector the company to which it belongs, for example, sectoral based classification could be mining companies, royalties' companies, oil exploration companies, investment and banking companies etc. The important ratios with respect to each of these sectors can be identified and be incorporated by the companies themselves to deliver the information to the investors.

7. Various accounting standards setting bodies (like IASB, Institute of Chartered Accountants of India and others) should think on these points to make the changes in the format of cash flow statement.

Conclusion

Cash flow statement can reveal lot of information to various investors especially the retail or small investors. The number of small or retail investors investing in the capital market have grown many folds. It has become an essentiality to revisit the format of cash flow statement. We believe that the above-mentioned suggestions would be of immense use to revise existing format of cash flows statement and to come out with the better informatory and meaningful cash flow statement.

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