

THE IMPORTANCE OF CASH FLOW IN UNDERLINING COMPANIES FINANCIAL POSITION

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Resume

Cash-flow analysis involves the movement of cash into and out of the business in order to determine the company behavior regarding actions that create and those who consume cash in a business cycle. In this article is presented the importance of cash flow in making long or short term decisions that lead to a healthy business growth. Movements of cash from activities illustrates a growth or reduction of cash in a certain period of time. Forecasting cash flow is useful to both managers managing company finances and banks to base lending decisions.

Keywords: cash flow, indirect method, lending decisions, creditor.

Classification JEL: G

1. INTRODUCTION

The cash flow shows the way money gets in, flow throw and get out from an organization. The cash flow statement is independent from companies financial sheets like Profit and Loss Account or Balance Sheet and has an immediately impact over the result of an exercise in contrast to the company stocks reflected in balance sheet that have a variable impact.

Cash is the fuel that makes the business go, without a healthy cash flow a business can not survive. Analysig cash-flow involves the movement of cash to and from business to determine the firm's behavior regarding actions that produce and those who consume cash in a business cycle.

The objective is none other than to maintain sufficient cash every month in the company allowing resumption of operational cycle and cover all other payment obligations arising: from loans or bonds, to shareholders or to invetment. In practice are used two models to highline the inflows and outflows from the company, both leading virtually to the same result. Each has its advantages and limitations.

When elaborating the cash flow sheet it goes from companies Net Result that results from Profit and Loss Account and contains information regarding inputs and outputs of cash in a certain period of time.

The more liquid assets in an organization are so the organization can pay its current debts faster.

2. CASH FLOW AND ITS IMPACT OVER COMPANY BEHAVIOR

The Cash flow statement provides different information for each individual:

- For managers, a cash flow statement it is important for being able to tell if there are enough resources in order to pay debts and the time needed to have the necessary resources
- For investors, it is important because it can realize easily if sufficient cash is being generating by the organization and the way that leads to it
- For business analysts, Cash flow is relevant because it shows whether an organization can make payments to close loans to third parties

Cash flow statement begins with the net result of an organization or revenues minus expenses. Not all income and expenses that are recorded in the Profit and Loss Account are being

found in cash.

Cash flow reflects all adjustments made on the assets and liabilities, an increase in active accounts is deducted from the net result, while an increase in the liability accounts is being added to the net result. In this way a decrease in accounts receivable has a positive role on cash flow and a decrease in debt account has a negative effect over the cash flow.

Net cash at the end of an analyzed period sums the net cash from the beginning of the period plus the cash from:

- Operating activities - covers changes taking place in accounts receivable, debtors, inventories and payments for taxes and interest
- Investing activities - refers to fixed assets adjustments and tangible fixed assets
- Financing activities – refers to financial items such as repayment of loans, issuing shares, dividends
- Elements of accounting equation influence cash flow in various manners, such as:
 - Stock for example if there are presented in an organization means that cash was spent to acquire or create the specific asset. An investment in stocks generate a reduction in cash from operating activities, in this way an organization that has too much stock, even though it has many assets, may have less cash. To increase cash flow the production process should be slowed (in order to reduce consumption or to be slower material purchases) or to reduce the volume of stock through sale
 - Accounts Receivable - shows in the cash flow how much from company sales has not yet been paid. To increase the cash flow is needed to reduce the debt collection or customer payment deadline
 - Accounts of debt - reflects how much an organization owes to creditors (suppliers, banking institutions, state partners). Increasing cash flow can be achieved by increasing the term of payment to creditors or reducing purchases, acquisitions

3. THE NEED OF CASH FLOW ANALYSIS

The cash-flow analysis involves analyzing the movement of cash to and from business to determine the firm's behavior regarding actions that produce and those who consume cash in a business cycle.

In managerial practice indirect method is often used because it is easier to build. Either method used, in principle there is a segregation of cash inflows and outflows in three categories: operating activities, investment and financing activities.

Cash-flow is very important also in lending decision by creditors. In order to contract a loan the bank uses indirect method for analyzing working capital loans (short term prediction) respectively the direct method for analysing investment loans.

Cash-flow from the creditors perspective has in consideration a critical question: "Can a loan agreed today be repaid tomorrow"?

Projections permits creditors to achieve several objectives:

- Establishing a certain probability of a result if the future would continue the trend of the past
- Determination according to the company profile, of what types of assumptions (developments) can be sustainable
- Identifying a variable amount of threats or opportunities and the level to which they may be acceptable

The creditor can use this tool to:

- Outlook business trend
- Measuring maximum loan amount that a client can pay it in a certain period of time
- Monitoring business accurately and quickly after the granting business credit
- Restructuring of loans with repayment problems

Comparing financial statements from two successive periods and calculating the change in the balances of assets and liabilities between current and previous period tells us how money were being produced and how money were used in that time period in a company.

In fact, changing each asset or liability releases or consumes cash in the company, following two rules:

1. A company generates cash:
 - by reducing an active position
 - by increasing a liability
2. A company consumes cash:
 - by increasing the asset account
 - by reducing a liability account

4. HIGHLIGHTING CASH-FLOW METHODS

The two models: direct and indirect method of cash flow used to highlight the inflows and outflows from the company are both leading virtually to the same result. Each has its advantages and limitations.

The two embodiments of cash flow are known under the names "direct method cash flow" and "cash flow indirect method". It is being said that without cash flow analysis it is like you drive through rain with your wipers work without water. Cash flow - it's especially important for lenders because it's the only instrument that can measure with some accuracy the amount of cash necessary to cover rates and interest payable in future periods and can identify sources of the respective cash.

In order to obtain a projected cash flow using the indirect method, the financial model is based on providing financial statements helper that collect financial data from the trial balances and summarizes them, hereinafter called predetermined situations. These financial statements projection will provide future levels of asset and liability account balances, as anticipated profit levels.

As a direct consequence, will result and the necessary financial resources necessary to sustain estimated business volume. Defaults Financial statements and the result – the indirect cash-flow, are the tool mostly used in financial planning. This is usually followed then by detailed operational plans and budgets, which are management key and control of implementation estimated in financial objectives.

$$\text{External resources required} = \text{Total assets} - (\text{Short time debts} + \text{Long time Debt} + \text{Equity})$$

If the direct method is recommended for accurate and detailed presentation of sources and uses of cash in exchange the method has the disadvantage that it is a more complicated and laborious method. In managerial practice indirect method is often used because it is easier to build. Any method that would be used, in principle there is a segregation of cash inflows and outflows into three categories: from operating activities, investment activities and financial activities.

The indirect cash flow presented provides information on the "balance" or "imbalance" of the balance sheet caused by different management decisions of the company, but especially on the existence or lack of cash in order to cover all categories of payments due during the forecast.

A basic but very important thing to take notice when analyzing a company's financial capability is "Where is the cash coming from and where it is being spent in a given period". At first glance one might say that Profit and loss Sheet could provide answer to this problem, but closer analysis shows two drawbacks: the current system of income registration does only show the sales charged and sales invoiced, plus does not show only sales and expenses recorded in that period but relating to periods before or after. The second drawback is that not all receipts or payments are reflected in Profit and Loss account Sheetⁱ and not all expenses are also paymentsⁱⁱ.

Evaluation of past financial statements and historical performance gives us important information to forecast future performanceⁱⁱⁱ.

The activities of a company, the way it organizes its operations, the existence or absence of a competitive strategy, all are reflected in its financial structure. The reverse is also true: the management decisions of a financial nature, in fact can significantly affect operational structure. Therefore the management plays a key role in how it is managed Cashflow:

- The way the shareholders decide to finance the acquisition of fixed assets of organizations will have an effect on leverage, profitability and the company's investment policy for the next few years;
- The decision to continue or not to finance working capital deficit by the parent company will significantly affect the relationship with suppliers and, consequently, operational model adopted by the company.

5. CONCLUSIONS

Forecasting cash flow by direct or indirect method is useful to both managers managing company finances and banks to base lending decisions. In managerial practice indirect method is often used because it is easier to build

Creating a cashflow forecasts should not be a difficult process, but the involvement of managers / entrepreneurs is essential because the projection relates to the management objectives, intuition and knowledge of business details and to respect some basic principles.

Management has to assume assumptions on sales, EBITDA, operating and investment cycle and develop action plans to achieve these quantitative targets.

The main drawbacks of the model regard the following two aspects:

- The model depend on the sales forecast, quite unpredictable element in the context of a highly volatile business environment
- The model captures the seasonality more difficult and risks that generates from it, especially related to seasonal peaks of financing needs

ⁱ for example Revenues in advance or loan installments

ⁱⁱ For example Depreciation and provisions

ⁱⁱⁱ Cyclical cash generation

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