LIQUIDITY AND FINANCIAL FLEXIBILITY USING THE CASH FLOW STATEMENT

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Abstract

The primary objective of the business is to continue its existence. However, businesses are affected by many variables in an incresingly competitive environment. These variables also affect the financial structure of the business. Composition and maturity of the financial resources of the business change rapidly, depending on its liquidity and solvency. Liquidity and solvency requires a regular cash flow. Therefore, cash management is the key to business continuity. In this study has examined it is measured liquidity and financial flexibility using the cash flows. Cash flow statement data is used in ratio analysis. The benefits of cash flow ratio has evaluated in terms of lenders and shareholders. Finally, the use of cash flow ratios in financial analysis has examined in Turkey. In addition to the liquidity ratio in the financial decision making process has been proposed the use of cash flow ratios.

Keywords; Cash flow statement, financial analysis, liquidity, financial flexibility

1. Introduction

The survival of companies in a highly competitive environment can be achieved basically through their good management skills and by the provision of sufficient resources, and through the effective distribution of these resources among the assets. Regardless of their field of activity, size, target market and the regulations they are subject to, the vital factor for the companies is the sustainable management of the cash flow, during all stages starting from their foundation, to investment and operation cycles. The operation of all business functions can be achieved only when there is sufficient amount of cash, which is provided on time, is well distributed, provided based on need, as the cash flow grows larger at the end of each period at a sufficient level for the financing of growth and development. For this reason, aside from basic operational functions such as production and marketing activities, entrepreneurs and managers spend most of their time focused on financial policies and financial management. Since working capital financing has a short-term structure, the liquidity of the company is measured when making financing decisions. However, investment financing gives rise to the need for significant amounts of long-term financing; therefore, the capital structure and cost are analyzed first.

In this study, we are going to discuss the use of a cash flow statement for the purpose of determining the liquidity and financial flexibility. It has a significant role in the making of investment and credit decisions by the investors, creditors and third parties, and finance decisions by the company managers. In addition, we will analyze the criteria followed by the companies in Turkey to prepare cash flow statements and their limits of use.

2. Literature Review

A cash flow statement is a financial statement in which a company’s cash inflows and outflows for a certain period are recorded and divided into sections based on operating activity. They provide information in relation to the finances. A cash flow statement is used by third parties for the purpose of making credit analysis, solvency estimates, financing of investment requirement and in the evaluation of the quality of income generated as a result of business activities. (Body and Cortese-Danile, 2000). The analysis of cash flow statement reveals vital information both for the measurement of performance and the determination of the company’s future growth potential (Stamankovich and Pavlovich, 2011).

According to IAS 7 Cash Flow Statement Standards, published by the International Accounting Standards Board on December 1992, and came into force on January 1, 1994, the purpose of this table is to provide information on the changes that occur in the cash and cash equivalent assets. In the cash flow statement, the cash flow for a relevant period is reported under three sections: business administration, investment, and finance activities.

Liquidity is a company’s ability to punctually meet its short-term obligations that are due and payable (Schuppe, 1993). In the traditional ratio analysis, to discover the company's solvency, the amount of working capital is determined and current assets and short-term liabilities are compared. However, in the liquidity analysis that are based on balance sheet data, the weak points are whether the current assets can be entirely converted into cash or not and the fact that the balance sheet data indicate a situation at a specific date on the balance sheet.

Even though the acid test ratio is focused more on liquid assets and leaving inventories out of the calculation, it is based on the assumption that the receivables cannot be collected fully and on time. Therefore, due to the reason that the traditional liquidity rates are based on the assumption that the inventories and receivables will be converted into cash within an accounting period, when unsold inventories and uncollected receivables are present, the liquidity estimates cannot be achieved (Mautz and Angell, 2009).

Mills and Yamamura (1998) state in their study that the use of cash flow statement in the liquidity analysis is more reliable than using an income statement, which contains items such as a balance sheet , non-cash depreciation and retirement benefits. Martinson (2000) states that a cash flow statement reflects the changes and the net effect of the entire accounting process by focusing on the cash used for business activities.

Financial flexibility refers to the capacity of a company to preserve its liquidity and supply cash against unexpected fluctuations that occur in an operational environment. In this sense, the capacity of the companies to access cash in case of unfavorable and tough market conditions is of critical importance in terms of facing bankruptcy risk. It has been observed that the companies that have financial flexibility prefer a prudent debt management policy with respect to their financial policies (Ferrando, Marchica and Mura, 2014). The sudden and sharp reduction in their liquidity, especially in times of economic crisis, cause companies with strong liquidity and financial structure to be less affected from adverse economic developments.

In the measurement of capacity of liquidity and solvency, the creditors focus on the operational cash flow section of the cash flow statement. In that section of the cash flow statement, the difference between the cash inflows and outflows related to the core business of the company is recorded. Operating cash flow ratio is calculated by dividing cash generated from operational activities by the short-term debt (Kirkham, 2012).

Operating Cash Flow Ratio = Cash Flow from Operations / Current Liabilities

This ratio gives more clear results than the traditional liquidity ratio, because it shows to what extent the short-term debt is met by the cash generated from the operations. However, Mills and Yamamura (1998) state that the sector in which the company operates must also be taken into consideration when analyzing the calculated ratio. The operating cash flow of companies that operate in capital-intensive sectors is significantly less compared to the operating cash flow of companies that operate in the gambling industry.

In case the company decides to distribute dividends, the operational cash flow can be calculated in more detail in order to more accurately calculate its solvency in relation to short term debt.

Cash Debt Coverage Ratio = Cash Flow from Operation-Dividends / Total Debt

In this case, the cash that remains after deducting dividends from income generated from operating activities must be compared to short-term debts. The sector’s structural characteristics must be considered when evaluating the ratio (Mills and Yamamura, 1998).

The cash flow statement’s most important elements that are used in liquidity analysis are the operational net cash amount. The net cash generated from a company’s operations is the main resource for payment of current liabilities as well as financing expenses. In this sense, the operational net cash amount is expected to be compared to financing expenses and the ratio is expected to occur at a high level (Ibarra, 2009).

Cash Interest Coverage = Cash flow From Operations + Interest / Interest

3. The Use of Cash Flow Statements for Analysis of Liquidity and Financial Flexibility

Companies can only carry out their activities in a consistent manner and fulfill the expectations of their stakeholders when they have a stable cash flow. A regular and sufficient amount of cash flow is required for the employees to receive their salaries regularly, to make dividend payments to shareholders, to timely pay taxes and insurance premiums, and to pay trade payables, loan interests and principal payments without disruption.

Otherwise, financial failure occurs. Moreover; the most significant common problem of companies that carry the risk of bankruptcy is their failure in realizing liquidity and financial flexibility.

Accomplishing a regular cash flow in a business depends on the following factors:

- The current assets must have the ability to be converted into cash, in other words they must have high rate of liquidity,
- Sales and collection of receivables must be done regularly,
- The company must have sufficient working capital to continue its activities,
- Current assets and current liabilities' maturities must be in agreement,
- Current assets and current liabilities must be in agreement in terms of foreign exchange (currency),
- In case the cash flow is interrupted due to any reason, immediate and sufficient amount of resources must be available,
- Company managers must be able to make decisions that will affect the cash inflows and outflows without any pressure,
- They must have a well-managed decision support system for financial management.

Liquidity analysis is in fact an adequacy analysis; therefore, the financial statements subjected to analysis must reflect this adequacy as accurately as possible. Almost all of the above mentioned elements can be obtained from the data included on the balance sheet and income statements. However, if we want to see when the cash requirement or cash surplus will arise and in what amount, then these can be found in the cash flow statement. Nevertheless, the measurement of a company's performance and cash-based shifting of the asset/resource balance can also be seen in the cash flow statement.

If the cash and cash equivalents on the balance sheet are satisfying a company's very short-term liabilities, then this will enable the company to overcome sudden crises without injury. However, the most important point is realizing the targets for growth and profitability together with financing of business operations.

In this case, the ability to provide financing also becomes important. The companies with high liquidity have a chance to find funding in higher amounts, at higher quantities and to find resources from a wider range of sourcing. Therefore, they can choose the cost of funds as well as negotiate favorable payment and guarantee terms. Financial flexibility of these companies is high. Therefore, there is a positive correlation between liquidity and financial flexibility. This correlation is reflected in a cash flow statement as limited cash outflow due to low funding cost despite the high operational net cash.

4. Preparation and Use of the Cash Flow Statement in Turkey

Businesses operating in Turkey prepare their financial statements in accordance with the Uniform Accounting System. However, the following companies must keep their records in accordance with the Turkish Accounting Standards in addition to the Uniform Accounting System and the Turkish Commercial Code: The companies whose capital market instruments are offered to public, the companies who are subject to the regulations of the Banking Regulation and Supervision Agency, and the companies who are deemed to be publicly traded due to the Capital Markets Law, although, their instruments are not offered to the public.

According to the Uniform Accounting System (ICCPA, 2014), the cash flow statements are not included in the basic financial statements. The obligation to prepare a cash flow statement, which is listed among the additional financial statements, is limited to the following companies: The above mentioned companies who prepare their financial statements in accordance with the Turkish Accounting Standards; and the companies whose total assets exceed 13.3 million TL; or whose turnover exceed 29.6 million TL for the year 2014. For this reason, especially the small and middle-sized companies are not obliged to prepare a cash flow statement.

When companies don't prepare cash flow statements, the stakeholders have limited information about their cash status. With regard to these companies, sudden cash shortages can occur, especially in times of economic fluctuation when there are delays in the collection of receivables. However, these companies' cash flows cannot be clearly determined by the banks' credit analyses, which is one of the main sources of cash supply. The absence of a cash flow statement, as a supportive element in the ratio analyses beyond the balance sheet and income statements, leads to lower chances of making accurate credit decisions.

Even if the banks create estimated cash flow statements based on balance sheet and income statements, the fact that these financial statements have insufficient or absent footnotes causes to problems in the determination of cash needs. The companies who prepare and present cash flow statements increase their credibility due to better chances of an accurate evaluation by third parties and because of their transparency.

In Turkey, in the recorded sections of the companies' financial statements and activity reports that are approved by independent audit companies, there is not sufficient documentation regarding the cash flow statement. In the analyses made through the financial statements, the ratios obtained from balance sheet and income statements are used. In the basic analysis reports prepared by the intermediary companies operating in the Istanbul Stock Exchange, the cash flow statement is included as a summary for the companies whose shares or other securities are publicly traded; however, it is observed that no work is carried out to determine the ratio for supporting the liquidity analysis based on the cash flow statement. In the Central Bank of the Republic of Turkey's publication on sector reports, balance sheets, income statements, and fund flow statements are included in each sector.

5. Conclusion

A Cash flow statement provides a cash-based summary of the balance sheet and income statement. In order to get accurate results, especially in liquidity analyses, the companies should test the results by also including the cash flow ratio to traditional ratio analyses made by using the balance sheet and income statements. Doing this would be beneficial in two respects:

- Since liquidity is related with the provision of a sufficient amount of cash in time, using a cash-based statement increases the accuracy of the decisions.
- By using the cash flow statements, which show a company's operations divided into three groups, the use of cash that was obtained from operating activities and from other activities can be clearly observed. Funding possibilities for future investments and financing needs are observable.

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Figen Esin has completed her Ph. D. at the department of Business Administration, İstanbul University in 1999. During 1993-2009, she held positions as a financial analyst and credit manager at commercial banks in Turkey. Date from 2010, she is an assistant professor of Accounting and Financial Management at the School of Applied Sciences, Okan University. Her research activities have focused on financial decision support systems, fuzzy logic in financial management and management accounting.