CHAPTER I

INTRODUCTION AND BACKGROUND

Introduction

It has been emphasised that accounting has to be in tune with social and economic environment of a country. The role of accounting has been changing with the growth in the social, economic, political and legal environment. It has to play an important role in measurement and communication of necessary information to different groups of users of accounting reports to enable them to make rational decisions.

During the last fifty years, in each stage of growth of the entity and the needs of its users, emphasis on financial statements has changed. Growth in needs of users has led to preparation of additional and new financial statements.

Up to 1960s, Balance sheet and Profit & Loss account satisfied the users. When the companies encountered "liquidity crisis", the users found that the Balance sheet and Profit & Loss account were inadequate for predicting such crisis. The standard setters felt in thinking about disclosure of changes in financial position to overcome such deficiency.

There was a need to know the reasons of changes in financial position, which were not apparent to users from the Balance sheet and Profit & Loss account. Because the amount of profit which was
computed according to the accrual basis misled the users. They had found that value judgement on the basis of profit alone is not sufficient to ensure the continuing survival of a firm. Funds flow statement was another report, which was suggested for giving more information about liquidity. In funds flow statement, fund could be considered as cash or some other form of liquidity. Preparation of Funds flow statement during 1960s-1970s was with emphasis on working capital concept of fund.

The most significant failure of Funds flow was inability to disclose the availability of cash. It was found that the growth and survival of an enterprise depends on its “liquidity”. And to manage the liquidity there is need of enough information about time and amount of “cash inflow to” or “cash outflow from” the enterprise. So Cash flow statement was suggested by standard setters as a report that can be a fundamental aspect of reports upon which liquidity management is based. All the information about inflow and outflow of cash is summarised in Cash flow statement.

However, some believe advocacy of Cash flow reporting has been closely associated with the limitations of accrual accounting procedures not necessarily with specific problems with funds flow statement or intrinsic usefulness of the Cash flow statement. Limitations of accrual measurement process, especially with respect to the subjective and arbitrary nature of allocations are seen to be particularly manifested in the determination of earnings.

1 Normally “some other form of liquidity” even in the context of Cash flow is not considered or viewed. However, it has been noticed in the presentations of some of the Balance Sheets of reputed Indian companies (Hero Honda 17th Annual report 1999-2000, page 58) that liquidity which consists of cash and cash equivalent is composed of the following five items: 1) Cash credit from banks, 2) Working capital loans from banks, 3) Short-term loans from banks, 4) Packing credit loan, 5) Cash and bank balances.
Hence, preparation of Cash flow statement has been suggested as a measure to provide valuable information to users who are concerned with an enterprise's liquidity.

Background

Realising the significance of the Cash flow statement in 1996, the Securities and Exchange Board of India (SEBI), issued a directive to all recognised stock exchanges asking them to include a requirement of providing for Cash flow statement information as part of listing agreements. SEBI also suggested the pro-forma for the preparation of Cash flow statement. Mumbai Stock Exchange made this provision compulsory. According to its clause No.32 all the listed companies whose annual reports would be prepared after 31 March 1996 would be required to include a Cash flow statement in their annual reports. Meanwhile, the Institute of Chartered Accountants of India issued an Exposure Draft on Cash flow statement, and accordingly Cash flow statement supersedes AS.3, *changes in financial position*, which was issued in June 1981.

With these movements, India has joined an increasing number of Western countries that have adopted accounting standards on Cash flow statements.

In the USA, FASB 95 “statement of Cash flows” was made effective for the fiscal year ending after 15 July 1998. It was subsequently modified by FASB 102 and 104. In the UK, FRS NO.1 “Cash flow statement” was issued jointly by the Accounting Standards Board and
the Institute of Chartered Accountants in Ireland in September 1991. In New Zealand Statement of Standard Accounting Practice (SSAP) No. 10 “statement of Cash flows” issued by the New Zealand Society of Accountants in October 1987 requires presentation of Cash flow information in the financial statements. In July 1988, the South African Institute of Chartered Accountants issued the Statement of Generally Accepted Accounting Practice No. 118, “Cash flow Information” which requires inclusion of Cash flow statement in a set of financial statements. In Australia in June 1991, Australian official standard-setting body, Australian Accounting Research Foundation (AARF), issued a Cash flow standard on behalf of the Australian Accounting Standards Board (AASB) No. 1026. All public companies were required to comply with the new accounting standard later than June 1992.

The shift in advanced countries corporate and regulatory opinion to the importance of Cash flow statements in the 1970s can be directly attributed to an unprecedented increase in the number of corporate collapses during this period because of cash crisis. In the light of numerous companies’ collapses, auditing and accounting profession became the target of user criticisms. The users believed if the financial statements had been designed to help business, these firms that ended in bankruptcy might have been saved. Without doubt these developments had an impact on growing interest in Cash flow statements.

While the Cash flow statement has, for some time now, been on the agendas of international standard-setting bodies, the development of India’s interest in the issue has been preceded by almost no significant research attention being paid by Indian academies.
In contrast to Cash flow development in the USA and UK, there has been very little systematic, empirical research on the importance of Cash flow statements in India. A review of several Indian journal reveal that there are very few articles and manuscripts published on Cash flow reporting. However, India has accepted this new aspect because of the policy of liberalisation and globalisation, as the information of Cash flows statement is required basically for foreign investors.

Though study relating to Cash flow analysis would appear to be a totally new theme for research in India, while collecting information about review of literature pertaining to this topic, the researcher has came across three specific research. They are referred to in chapter two on page 22.

Though the theme of research of M/S Jones, Romano and Smyrnios appears to be very similar to this study undertaken, the main difference is that M/S Jones, Romano and Smyrnios have collected data as a response to a questionnaire. So this is an impressionistic survey. Hence, response to questionnaires may not be leading to accuracy of data. ²

As a result, the relevance and utility of Cash flow statements to the economic decision-making of users is yet to be demonstrated empirically in this country. So it presents an immense scope.

Against this background of the Cash flow statement at the national and international level, this study has been undertaken. This study basically undertakes the accounting aspect of the Cash flow statements.

When the researcher came to India to study the most modern theme in accounting, which has practical significance in accounting as well as finance, through the exploration of the researcher's guide, the study of Cash flow was identified. One senior officer from a development bank had expressed in a dialogue with the researcher's guide that it was very difficult to understand the information provided through Cash flow statements. Therefore, it made the researcher curious to know what aspects lead to difficulty in understanding. And many difficulties have come to light through this study, which are highlighted in the thesis. The significance of this theme was realised when the researcher undertook the review of earlier literature regarding Cash flow.

The following chapter scheme has been adopted to present outcome of research.

Chapter II deals with the review of earlier literature regarding Cash flow. It contains review of earlier relevant literature in the area of Cash flow techniques used in financial statements prior to introduction of Cash flow statement as a part of financial operations. In this chapter, relevant literature is studied from different angles:

1. Review of development of standards set-up by different countries,
2. Review of articles published in journals, and
3. Review of specific books on the subject.

The above subject matter has been divided into three parts:

In the first part reference has been made to development of accounting standards and concepts related to Cash flow statements in
USA, UK, Australia and India. In the second part the articles published in foreign journals and Indian journals have been given chronologically. These articles have summarized varied views, opinions, and commands pertaining to theory and its practical utility in accounting of the concept of Cash flow. In the third part the survey of earlier literature consists of twenty-six books. Most of these books belong to recent origin. Articles and books, both Indian as well as foreign, have been listed.

Chapter III discusses the objectives, the purpose and scope of the study apart from covering other aspects namely hypothesis, method of data collection, relevance of the study and limitations of the study.

Chapter IV is the backbone of the study. It discloses results of collected data. These results are supported by statistical techniques, such as classification and frequency distribution, measurement of results on the basis of percentages, etc.

Chapter V, as a final chapter, recapitulates the observations and conclusions of the study. Certain suggestions are incorporated and the areas of further research are also spelt out.