CHAPTER II

REVIEW OF EARLIER LITERATURE REGARDING CASH FLOW

This chapter contains review of earlier literature in the area of Cash flow techniques used in financial statements. Prior to the introduction of Cash flow statements as a part of financial statements of corporations, financial information was disclosed through Profit & Loss account, Balance Sheet and Funds flow. In this thesis reference to relevance of Funds flow in financial statements has been explained elsewhere. This chapter contains the following aspects of review of relevant literature studied from different angles:

A- Review of standards setup by different countries
B- Articles published in journals
C- Specific books on the subject

A- Review of Standards Setup by Different Countries:

It has been emphasized that accounting has to be accompanied with social and economic environment of a country. Therefore, developments in accounting practices, principles and procedures have to keep pace with the changes in economic, social, legal and other environment prevalent in a country. A brief review of the development of accounting
standards and concepts related to Cash flow statements, in USA, UK, Australia and India have been detailed here.

a) In the United States of America (USA):

History of standards includes information relating to Funds flow as well as Cash flow statement. In 1920s, Finney familiarized Funds flow statements. In 1960, Perry Mason developed it. In 1961, the American Institute of Certified Public Accountants (AICPA) issued ARS No.2 "Cash flow Analysis and the Funds Statement", which recommended that a Funds flow statement which is covered by an auditor’s opinion, be included in financial reports of companies.

In 1963, the Accounting Principles Board (APB), observed that increased attention has been given to flow of funds analysis, and issued opinion No.3, “The Statement of Source and Application of Funds”. This opinion suggested that Funds flow statements should be presented as supplemental information in financial reports but did not make such disclosures mandatory.

In 1970, Securities and Exchange Commission (SEC), issued Accounting Series Release (ASR) No.117, which required companies registered with the SEC to include a Funds flow statement in their annual reports.

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2 Ibid., p. 257.
In 1971, the APB noted that regulatory agencies were requiring the preparation of Funds flow statement and that a number of companies were voluntarily preparing such statements. As a result, the Board issued APB, opinion No.19, which stated that information usually contained on the Funds flow statement was essential to financial statement users and that such a statement should be presented each time a balance sheet and income statement was prepared.

In 1981, the FASB issued an Exposure Draft (ED) of a “Proposed Statement of Financial Accounting” concept which consists the reporting of Funds flow. This ED emphasized cash concept of funds rather than working capital or any other concepts. This was the real beginning of Cash flow statements. In December 1984, the Statement of Financial Accounting Concepts (SFAC) No.5 states that Funds flow statements should be prepared by “cash concept” of funds rather than “working capital” or any other concepts.

In USA in the 1980s, a large number of companies reported bankruptcies. It revealed weakness of Funds flow and working capital statements prepared by them. The need for information about flexibility and liquidity on one hand and inefficiency of other reports for such information on the other hand, led to another statement. So in November 1987, FASB issued SFAC No.95, “Statement of Cash Flow”. The Funds flow established, as a requirement by APB No.19, was no longer used. In 1989, the FASB issued statement No.104, “Statement of Cash flows – Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash flow from Hedging Transactions” which improves FASB No.95. This amendment affects bank and financial institute reporting.
b) **In the United Kingdom (UK):**

In the UK, in 1975, the Accounting Standard Board issued the Statement of Standard Accounting Practice (SSAP) No. 10. It lays down a minimum standard of disclosure for statement of sources and applications of funds. It required that a Funds flow statement should be part of all audited financial accounts, intended to give a true and fair view of financial position other than those of enterprises with a turnover less than £ 25,000 per annum. In this standard, funds are defined as working capital.

In September 1991, the Accounting Standard Board (ASB) issued its first Financial Reporting Standard, FRS No.1, “Cash flow Statement”. The standard supersedes the SSAP No.10, and it should be adopted by companies related to reporting periods ending on or after 25th March 1992. According to FRS No.1, large companies have to produce a Cash flow statement as an integral part of their annual accounts.

c) **In Australia:**

In June 1991, Australia’s official standard setting body, the Australian Accounting Research Foundation (AARF), issued a Cash flow standard on behalf of the Australian Accounting Standard Board (AASB). According to AASB 1026, Cash flow statement replaces the Funds flow statement. The new accounting standard has become a compulsory part of Australian corporate financial reporting.

So all public companies were required to comply with the new accounting standard by no later than July 1992. The accounting standard
covering the Funds flow statement ASRB 1007, Financial Reporting of Sources and Applications of Funds was simultaneously withdrawn in June 1992.

d) In India:

In June 1981, the Institute of Chartered Accountants of India (ICAI) issued Accounting Standard (AS) No.3, “Statement of Changes in Financial Position” which is commonly known as Funds flow statement. However, this statement is not mandatory, but there was a growing interest to prepare such a statement along with other financial statements. The objective of AS No.3 was to encourage the companies to prepare and include Funds flow in their reports, and realize the significance of these statements.

Of late the ICAI has issued an Exposure Draft (ED) for the revision of AS No.3. According to this ED, “Cash flow statement” is the substitute of Funds flow.

The Securities and Exchange Board of India (SEBI) has issued a directive to all recognized Stock Exchanges, asking them to include a requirement of providing for Cash flow information as part of listing agreements. SEBI has also suggested information that needs to be included for the preparation of Cash flow statement.

Mumbai Stock Exchange has amended clause No.32 of the listing agreement as per SEBI requirements. Accordingly, all the listed companies whose annual accounts would be approved after 31st March 1996 would be required to include a Cash flow statement in their annual
reports. But there is no standardized policy regarding preparation and presentation of Cash flow statement.

The working groups on companies Act (1997) have suggested inclusion of a “Cash flow Statement” as part of corporate financial statements.

B- Articles Published in Journals:

Review pertaining to articles published in foreign journals and Indian journals consists of twenty-eight articles. Out of these twenty-eight articles only one article is published in an Indian journal. In fact it is not a journal but one Indian newspaper. The summary of all these articles has been given chronologically. However, there is only one deviation. In case of these contributors to articles who have contributed more than one article, their summaries have been put together. So only in this case the chronology has been changed.

These articles move from one theme to another but relate to Cash flow statements only. They try to stress the significance of Cash flow in revealing information about Operations, Financing and Investment. They try to distinguish between Cash flow accounting, Cash flow analysis, significance of future Cash flow, their significance in investment decisions, Cash flow as a base for investment decision, etc.

Authors like Hicks lay stress on the ability of Cash flow in generating efficient cash and not income. Mr. Lee demonstrates the significance of Cash flow accounting by using two phrases, cash oriented and allocation free. Further he brings out the significance of financial
information for liquidity analysis. He further states that the purpose of entity analysis is to examine performance through Cash flow and not through profit, because the potential of Cash flow depends upon net realisable value. Another author Stabus focuses his attention on this subject by emphasizing the Cash flow potential and wealth of an organization through such analysis. In his opinion income is not important. Thus in this summary of articles published in journals, varied views, opinions and commands pertaining to theory and its practical utility in accounting of the concept of Cash flow is summarised in the following pages.

1) It is a usual practice to measure corporate performance in the form of earnings. However, Mr. Lawson (1971) thinks that Cash flow accounting is a better measure because it contains analytical framework for linking past, present and future. In his opinion Cash flow accounting helps investors in decision-making.\(^3\) Lawson's second article on the same theme has appeared in 1985. In this article he sees two dimensions of accounting, namely risk and profitability, to be considered from multi-period performance. The multi-period performance is the form of short-, medium- and long-term performance. So Cash flows have to be considered from the two dimensions and multi-periods.\(^4\)

2) According to Professor John Sizer (1975) the change to Cash flow techniques was due to liquidity crisis. It is necessary for companies to forecast effectively their working capital needs and Cash flow to predict liquidity and profitability problems. Such predictions help companies to


encounter unexpected deficits in Cash flow. In his opinion future Cash flows do not help in accounting profit. But such Cash flows can be used in capital investment decisions of short-term nature.⁵

2) Mr. Yuji Ijiri (1978) points out the discrepancies between investment decisions and their evaluation. His opinion is that Cash flows cannot be used as a base for investment decisions only. They must be used for evaluating performance also. The concept of earnings is secondary to Cash flows.⁶

4) Mr. Barry Hicks (1980) looks to Cash flows from yet another angle. He brings in the concept of income. In his opinion the ability of an organization to generate efficient cash is more important than generating income. Therefore, cash account is more important than the retained earnings account. He mentions four reasons for not accepting the earnings as a measure of evaluation of corporate performance. Like his predecessors, he also takes into account the significance of predicting future Cash flows as an aspect of analysis of the collected data on Cash flows.⁷ In his second article in 1981 he has gone away from the term income to earning. He believes that Cash flow bases of accounting

⁵ Professor John Sizer, “What We Should be Doing About The Company Liquidity and Profitability Crisis?”, Management Accounting, October, 1975, p. 75.
should be a substitute of earning statement. In financial accounting theory Cash flow helps in revisioning in the past.8

5) Mr. Lee has contributed three articles on uses of Cash flow information under three different headings of papers contributed by him in 1980, 1983 and 1985. In his first article (1980) he stresses the advantage of Cash flow accounting as a net realizable value accounting which is capable of describing the operating activity and the financial position of a company.9 Like Professor John Sizer referred to earlier, he also believes in liquidity analysis. This he has brought out in his second article (1983).10 In his third articles Lee (1985) brings in another dimension of the term “profit”. To justify the significance of Cash flow he states that cash is a physical source and profit is an abstraction. Further, he says that the nature of profit cannot be ignored. The use of Cash flows depends upon potential Cash flows having net realizable value.11

6) Lepkowski (1980) makes a statement to show the relationship between working capital and Cash flow, wherein he states that increasing sale does not necessarily lead to increase in Cash flows.12

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7) Mr. Watts (1983) repeats some of the arguments reported earlier regarding the relationship between cash and profitability. Cash flow analysis is more significant according to him because measurement of profit is based on subjective judgements. In his opinion operating Cash flow is more significant than identifying surplus or deficit cash.\textsuperscript{13}

8) The only one supported among the critics to Profit and Loss account, as a source of disclosing entity performance, is Mr. Egginton (1984). Naturally his opinions are opposite to Mr. Lee and Lawson. Surprisingly, he believes in the requirements of Funds flow for liquidity measurement. He says Cash flow reporting has a limited function in the assessment of entity liquidity.\textsuperscript{14}

9) Mr. Yoram Kroll (1985) differentiates between accrual accounting and Cash flows in the context of the relationship with working capital. In his opinion estimating net working capital is difficult because of various reasons. Reconciling profit with changes in working capital can be estimated on the basis of the size and timing of Cash flows rather than approximation of actual Cash flows invested in net working capital.\textsuperscript{15}

10) Mr. Drtina and Largey (1985), point out the dangers in calculating Cash flow from operations. The difficulties according to them arise due to conceptual and practical problems in reconciling profit and Cash flow from operations. These are not actual Cash flows but the estimated Cash

\textsuperscript{13} H. F. Watts, "Cash flow Analyses for Performance Assessment", Management Accounting, April, 1983, pp. 40-41.


flows from operations. One of the reasons he has pointed out is due to defining the term "operations". If operation is activity, then it is difficult to distinguish between operating, financing and investing activities. Considering the fact that the modern Cash flow statements (which this thesis has discussed) reveal a host of information in point of view is difficult to accept.

In his analysis he had made a reference to Cash flows and Funds flow of transactions pertaining to acquisition and divestitures and has made the subject matter more complicated. Similarly he has brought in some concepts such as current account and non-current account and has made simple issues more complicated.  

11) Mr. Rayburn (1986) questions the role of GAAP statements. In his opinion managers in financial reporting may manipulate operating Cash flows and accrual accounting. He also questions the role of accrual accounting in estimating future Cash flows. Do they help investors in any way?  

12) Mr. Bowen, Burgstahler and Daley (1986) have tested security market responses to Cash flow variables other than earnings. Their research results are contrary to what has been found out by FASB. They have noticed that "net income plus depreciation and amortization and working capital from operations appear to be the best predict of Cash flow from operations".

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These authors refer to five different types of Cash flows:

I. Traditional Cash flow consisting of net income after depreciation.
II. Working capital from operations.
III. Cash flow from operations.
IV. Adjustment between Cash flow from operations and investments during the year.
V. Aggregating cash from financing activities, operating activities and investing activities.

It is this fifth type of Cash flow that has been considered in this thesis, which includes all the five subclasses of Cash flows. 18

13) Mr. Staubus (1989) introduces one more concept related to Cash flow. This is Cash flow potential and wealth. He differentiates between wealth and income and he considers that the Cash flows should be able to evaluate:

I. Future liquidity, and
II. Wealth and income. 19

14) Mr. Bernard and Stober (1989) relate Cash flow and accruals with stock markets. Their results are similar to the investigation by Reyburn referred to earlier. However, the research does not find evidence of any significant variation than what has been established earlier.20

15) Mr. Arnold, Mr. Clubb and Mr. Wearing (1991) have tried to establish relationship between Earnings, Funds flow and Cash flow on the basis of data collected in UK. Their finding is similar to Mr. Bowen and others. There is a correlation between earnings and working capital funds. However, positive relationship between earnings, Cash flow and Funds flow has not been established.21

16) Mr. Allister Willson (1991) has comments to offer on Cash flow statements prepared according to FRS No.1. In his opinion no useful information is provided to users according to this method. He assesses the Cash flow statement from the point of view of liquidity, viability and financial flexibility. One of his statements that capital expenditure is not for expansion but for maintaining existing level of operations is amusing.22

17) Mr. Pizzey (1991), points out why the changes have taken place in financial statements in switching over from Funds flow statement to Cash flow statement. Here we get the logical reasons for the shift such as evaluation of liquidity, financial flexibility and estimation of risk in future in the operations of a corporation. Funds flow does not provide an insight into these requirements.23

18) In the journal, Management Accounting, there is a column contributed by Prudentius (under assumed name) and two articles have

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22 Allister Willson, "Cash flow Statements Under FRS 1- Do they highlight what is important?", Management Accounting, November, 1991, pp. 42-43.

appeared in two different years. The first is in 1992 and the second in 1994. The first article refers to the change from Funds flow to Cash flow as a "purely cosmetic" change.\(^\text{24}\) In the second article in 1994, however, the opinion expressed is different. The writer has realized the utility of Cash flow statement from the point of view of identification of probable insolvent companies.\(^\text{25}\)

19) Mr. Sheldrick (1994) accepts the quality of the Cash flow statement in providing additional information to shareholders and creditors. He is critical about the term "cash equivalent". According to him one of the drawbacks of Cash flow statement is that it is more subjective.\(^\text{26}\)

20) Mr. Jones, Mr. Romano and Mr. Smyrnios (1995) have conducted research in Australia. In their opinion Cash flow statements are useful for decision-making. However, their effort to compare the role of operating profit and operating Cash flow as a measure of corporate performance brings us back to the theoretical controversies discussed earlier.\(^\text{27}\)

21) An Indian, Mr. Chhaya (1997), has an article that is based on a study of Indian companies in 1996-1997, regarding inventory build-up and overdue receivables. He agrees that Cash flow statement contributes to assessing liquidity and solvency of companies.\(^\text{28}\)


\(^{27}\) Stewart Jones, op. cit., pp. 115-129.

22) Mr. Divesh Sharma (1997), who is an active researcher in the area of Cash flow statement and its analysis, has conducted research in Australia. In his article he discusses how bankers can utilise the information contained in the Cash flow statement to assess the potential borrower’s ability to pay.

He has tried to highlight why traditional ratios may not reflect liquidity and the implications of the relationships between profit and Cash flow from operating activities.29

23) Mr. Goyal (1999) has tried in his article to show that reported earnings or their ratios are not useful measurements in predicting the ability of a firm’s internal cash generation, i.e., cash from operations.

He concludes ratio based on Cash flow figures provide useful information for evaluating a company’s financial strength and profitability. And disclosure of operating Cash flow per share is a better indicator of performance than earning per share.30

In the above referred twenty-eight articles contributed by twenty three contributors, it is noticed that the final shape of the statement of Cash flow has emerged out of many controversial statements, opinions and concepts. The pros and cons have been tested. Thus history of thought pertaining to Cash flow is traced through the above literature.


C- Specific Books on the Subject:

The survey of the earlier literature consists of twenty-six books. Out of these, twenty books are by foreign authors and only six books belong to Indian authors. About five books are between the period 1965-1986 and about twenty-one books belong to the period 1991-1997 i.e. they belong to the recent origin.

1) Mr. Jaedicke and Mr. Sprouse (1965) have accounted three different flows in a company: income flow, Funds flow and Cash flow. They argue that profit is no longer an accurate measure of economic health. Now it is important how much cash remains in the company after all payments, and the indicator of financial strength is Cash flow. They notice that profit is manipulated which makes it unreliable, and this fact that relying on profit information for judging liquidity of the company will be misleading. They also state that working capital analysis is proper for long-term financial decisions. In short-term analysis, Cash flow is more appropriate. They point out to the increase in the degree of automation. This has led to addition in the amount of depreciation during the past fifteen years.

2) Mr. Hendrikson (1974) shows the significance of cash not only by its purchasing power, which is transferable to others, but also as a base for all accounting measurements to be done. Most accounting measurements are based on past, present or expected flow of cash, and

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32 Ibid., p. 99.

33 Ibid., p. 119.
all decisions of investors and creditors are upon Cash flow in and out of an enterprise. 34

He also notices the fact that by complexity of economic activities it is doubtful if financial reports, which are prepared according to accrual basis, will be adequate for preparing useful information for users for predicting future activities. 35 Even they cannot provide useful measurement of a firm’s efficiency. He says, “Although the income statement and Cash flow statement are related to the same information over time, they represent different information and different concepts.” 36 Mr. Hendrikson has listed difficulties in preparation of Cash flows. 37

3) Mr. Glautie and Mr. Underdown (1976) believe both Cash flow and Funds flow are concentrated on the same type of information but they emphasize different aspects of financial management problems. They also list significance of Cash flow statements. 38 In their opinion, although some believe capital expenditure has a long life benefit for the firm, it must be considered as an expense in the year acquired. However, this is against the conventional accounting of income statement, which tries to match expenses and revenue. In spite of this, it is true that the impact on the financial resources is felt in the year of paying the expenditure. When we want to decide on Cash flow information, capital

36 Ibid., p. 245.
37 Ibid., p. 246.
expenditure must be considered as an outflow in the year that it is incurred. 39

4) Mr. Lascalzo (1982) notices the reasons of bankruptcy of companies and recognises that the reason of bankruptcy is insufficient liquidity and not accumulated losses. 40 Actually there is difference between earnings and Cash flow. These are two different concepts. Earning is an accounting concept, which is computed by conventional accounting statement. But Cash flow is based on receipts and disbursements of cash. However, most investors claim they are interested in earnings but really they are interested in dividends received. 41

5) Mr. Hawkins (1986) advocates Cash flow information. He says that Cash flow and the ability of the firm for obtaining cash can concentrate on the “financial viability” of the company, because it is cash which is needed for meeting maturing obligations. 42 But he criticises the amount, which is computed as Cash flow in traditional definition of Cash flow. It is not Cash flow but it is Funds flow. 43

When the above five books were perused, it was noticed that the authors have not contributed any new theoretical concepts relating to the method to be adopted for the preparation of Cash flow. It is likely that this was due to the fact that the Cash flow concept was yet to be germinated.

39 Ibid., p. 665.
41 Ibid., p.2.
43 Ibid., p. 131.
6) Mr. Gallinger and Mr. Healey (1991) say that Cash flow is an improvement over the Funds flow. They believe that the information of Funds flow is a very weak indicator of the ability of a firm to generate cash. However, the Cash flow statement also has a narrow point of view. Because its focus is limited on the cash transactions during the period and is in attention to the events that have occurred in the prior period or will occur in the following periods. Actually it focuses on the operation of the current period.\textsuperscript{44}

7) Mr. Siegal (1991) also believes that some expenses of accrual accounting leads to misstatement of earnings. He says that the evaluation of net income is done subjectively and management must be aware and omit the influence of these items of earnings. All the revenues and expenses which are far from Cash flow need more interpretation and those which are closer to cash receipts and payments must be considered more in evaluating the earnings. He believes that for increasing the quality of earnings, it must be closer to cash transactions.\textsuperscript{45}

8) Mr. Shapiro (1991) has pointed out to “Cash flow cycle” and non-stop flowing in and out of cash in a going concern situation. He says that simultaneously the working capital is also changing. But the distinction between cash from operations and working capital from operations is very important. Like Mr. Gallinger and Mr. Healey, Mr. Shapiro also believes that working capital from operations is a poor indicator of the ability of a firm to generate cash.\textsuperscript{46} He has emphasized that, in analysing


the ability of the firm to pay dividends, we must consider “free Cash flow”. In his view free Cash flow is “net Cash flow in excess of that needed to undertake all profitable investment opportunities.”

9) Mr. Malburg (1992) knows both Funds flow and Cash flow as tools for cash management. He believes that Funds flow with attention to changes in working capital can help management identify risks and opportunities. And Cash flow on the other hand helps a manager to have insight into some points, which are not achievable by Funds flow. Some of these points are as below:

a) To show the ability of the firm to generate future Cash flows,
b) Capacity of the firm to pay obligations and dividend,
c) The needs of the firm for external financing,
d) To show the difference of net income and cash receipts and payments,
e) To show the changes in financial position resulting from both cash and non-cash investing and financing transactions.

10) Mr. Porwal (1993) tries to justify Cash flow accounting. He thinks that Cash flow accounting is a necessity of the present world, because changes in environment need changes in accounting. He believes that in running a business efficiently, management must consider two financial aspects - profitability and liquidity. And just that accounting system which will be able to provide relevant, reliable and timely information on these two aspects could be useful in decision making. For

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47 Ibid., p. 88.
49 Ibid., p.145.
achieving both of these aspects, he suggests Cash flow accounting. He also says that this system also takes care of the changes in price and does not distort financial reporting. He has recorded about a dozen reasons stressing the significance and utility of Cash flow accounting to users.

11) Mr. Chockley (1994) emphasizes on the significance of operating Cash flow. He says that a company can generate cash from many sources but just operating Cash flow is reliable as a continuous source. So the focus of analysis must be not only on sources of funds but specially on operating sources of cash also. For judging the ability of the firm to pay its future obligations, operating Cash flow is important and it can be used as a base for estimating future liquidity. The major decisions of management which cause cash to flow are:

a) Operating decisions,

b) Capital expenditures decisions,

c) Stock decisions,

d) Customer credit decisions,

e) Supplier credit decisions,

f) Tax on profit of the company,

g) Financial obligations such as interest and dividend,

h) Investment decisions,

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51 Ibid., p. 308.
52 Ibid., p. 309.
53 Ibid., p. 315.
55 Ibid., p. 75.
i) Financing decisions.56

12) Mr. Stickney and Mr. Weil (1994) believe that use of accrual basis accounting creates the need for Cash flow statement. As a proof they point to profitable companies which have become bankrupt because of insufficient cash to meet their obligations.57 They state that the information derived from Cash flow statements help to evaluate the impact of operation on liquidity and evaluating the relation between Cash flow from operating with Cash flow from financing and investing activities. In their opinion the relation between these three parts of Cash flow is very important.58

They emphasise on the use of Cash flow information in financial ratios and criticize the use of current ratio or quick ratio, because their use is made at a specific point of time. So if this is unusually small or large at that particular time, the resulting ratios will not reflect normal condition.59

13) Mr. Peterson (1994) believes that firms can invest their current Cash flows in the hope of generating future Cash flows. Part of the financial analysis and decision-making of companies is related to predict future Cash flows to be expected from today’s investments.60 This future Cash flows can be provided from two sources:

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56 Ibid., p. 73.
58 Ibid., p. 238.
59 Ibid., p. 295.
I. Assets, which have been acquired as a result of past investment decisions, and
II. Future investment opportunities.  

14) Mr. Harold Bierman (1994) argues that Cash flow analysis, while favored by security analysts, is not a substitute for an earnings measure when evaluating the profitability of a company over a short time span during its useful life. He argues that the accounting earning is a more useful measure because it attempts at more accurate assignment of revenues and expenses to each time period. And he asserts that financial markets can understand the way in which subjective judgements influence the earnings. So it will not be confused with different accounting practices.

By using an example of a three-period investment in depreciable assets, he concludes that Cash flow analysis would vastly overstate the rate of return on investment. He argues that accountants should act to improve the usefulness of the earnings figures. Because determining the Cash flow of an investment over its life is easier than earnings.

15) Mr. Gitman (1994) believes that a Cash flow statement allows the analyst to evaluate the past and possibly the future Cash flows of a firm. By special attention to the different categories of Cash flow, management can assess the developments, which have occurred with the

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61. Ibid., p. 347.
63. Ibid., p. 142.
64. Ibid., p. 146.
company's financial policies. It can be a good tool for evaluating the performance of projected goals. He believes, however, Cash flow statement is not able to establish specific links between cash inflows and outflows, but it is a good statement for presenting inefficiencies of cash.65

16) Mr. Rao and Mr. Pramanik (1994) also recognise that Cash flow accounting is a need of changing accounting environment.66 They assert that this new system can present the true financial performance of an entity. It makes an analytical framework for connecting past, present and expected financial performance. In this system, financial activities and performance of an entity is described on cash terms and considers both aspects of profitability and liquidity for providing relevant, reliable and timely information for users.67 They believe this system needs a strong theoretical background, a developed measurement, a reporting framework and a vast empirical support.68

17) Mr. Moyer, Mr. Guigan and Mr. Kretlow (1995) also address earnings which is prepared according to a flexible practice of GAAP. It cannot indicate the performance of a firm. Cash flow concepts are clear, provide necessary information for financial resource allocation decisions, and give a bright measure of performance for investors also. They state that using conventional historical accounting for measuring performance may be manipulated by managers. So earnings which is

65 Lawrence J. Gitman, Principles of Managerial Finance, Harper Collins College Publisher, 1994, P. 90.
67 Ibid., p. 337.
68 Ibid., p. 349.
present in such a system will not be reliable. But Cash flow information omits all these weaknesses and gives reliable information.69

18) Mr. Fridson (1995) argues that the balance sheet and income statement solely will confuse financial analysts. By preparing Cash flow statement a new analytical insight will be available. He also believes that because of the ability of income statement to change very easily according to management performance, it will miss its ability for comparing. All these shortcomings of an income statement have got a privilege for Cash flow.70

One of the important points, which Fridson mentions, is the advantage of Cash flow to determine the stage of life cycle the company is in. He says that the needs of cash are different in each stage. Also as the risk of each stage is different, the analyst focuses his attention to analytical factors. For instance, he shows the need to cash and the risk of company in the primary stage of growth is different with the stage of maturing. In addition to these advantages, Cash flow gives information for assessing the flexibility of a company which is very important in proper planning for every situation. And also this statement helps to recognize the trend of activity and ability to predict problem incidence. In bankruptcy period, the value of assets, which are in historical cost on balance sheet, may mislead the analysts. But the information of Cash flow can be a good help.71

71 Ibid., pp. 102-104.
19) Mr. Hermanson, Mr. Don Edwards and Mr. Maher (1995) pointed that the advantage of Cash flow statement is that it can help the management to show the effects of past major policy decisions in quantitative form. Also, management can use Cash flow information for future financing decisions.72

20) Mr. Weston, Mr. Besley and Mr. Brigham (1996) believe to the necessity of Cash flow as well as profit. They argue the importance of profit but emphasize that continuing business companies need cash. And also it is important for shareholders to know expected future Cash flows to predict the value of their stock.73 They state that the relation between profit and Cash flow is not reliable. Therefore, users need forecasted Cash flows as well as profit projections.74

In both cases, value of the company which is related to existing assets which provide profit and Cash flows on one hand and opportunities of growth by making new investments, that will increase future profit and Cash flow on the other hand, cash is the essential. Because cash gives the ability of using the opportunities for buying new assets.75

21) Mr. Brealey and Mr. Myers (1996) assert in their book that accountants begin their work with cash in and cash out. But when they want to compute earnings, this data needs to be adjusted in two important ways.


74 Ibid., p. 86.

75 Ibid., p. 87
a) All the income will be considered as they earn without considering date for paying bills.

b) And expenses will be divided into current expenses and capital expenses. Current expenses will be considered as expenses in income statement without considering the time of payment and capital expenditure will not be deducted as expense in spite of its payment. Just part of it will be recognized as depreciation. At the end of this procedure, earnings will not be equal to cash. Except depreciation, other changes will be shown in working capital. Thus, changes in working capital should be considered for forecasting Cash flow. But they suggest you can put aside working capital and directly count the cash in and out of the firms.  

22) Mr. Sharma and Mr. Gupta (1996) have considered seven aspects, which are important for cash accounting. These aspects have been already considered earlier. But they believe that in spite of these advantages, Cash flows suffer from limitations in a comprehensive and clear definition of cash and narrow point of view. They state that working capital has a wider concept than cash. So Funds flow statement gives more complete picture than Cash flow. It is very difficult to accept this view.

23) Mr. Van Horne and Mr. Wachowicz (1996) count a number of advantages for Cash flow statement as the previous study, and believe that Cash flow statement is a good help to analyst and users. But its preparation is more complex than Funds flow. So sometimes Funds flow

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is prepared because it is easier. They assert that Funds flow is a useful tool for financial manager or external user for evaluating the uses of funds and determining how the firm can finance these uses. Indeed, past flows can be used for forecasting future flows. They say, however, Cash flow replaces the Funds flow statement for reporting cash inflows and cash outflows in three aspects. But as its concentration is only on cash, some important current period non-cash transactions are omitted. So the analyst still needs a Funds flow statement for fuller understanding of the firm’s Funds flow.

24) Mr. Bhalla (1997) argues about the Cash flow crises and declares the reasons of such crises in the occurrence of unexpected events which can influence inflows or outflows of cash. In traditional capital investment planning, it is assumed that the forecasted Cash flows actually occur. By such a narrow assumption, the analyst misses the effect of short-term financial crises on Cash flows. Therefore, it needs revision because:

“A dual simulation process is introduced with one assumed to represent the forecasted results and the other the actual outcomes. In simulating these two sets of conditions, the model assumes sales are the key mechanism. It is assumed that actual sales are generated by capital investment programme and a separate forecast of sales is produced by the working capital model. Simulating sales conditions where the actual sales are randomly different from forecasted sales captures the essence

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79 Ibid., p.164.
of forecasting errors, which incorporates the major cause of working capital problems.”

The author goes on to discuss the problem which causes crises. He also mentions Cash flow shortfall, and describes it as a main problem which causes working capital crises. Because management adjust working capital for offsetting such shortfalls. 80

Finally he suggests a revised model for Cash flow, and asserts that in this model, projected errors and inflation has been considered and sometimes makes it completely different from traditional model. The main objective of this revised model, he points out is the ability of the model to measure size and sign of Cash flows, and the ability to highlight the cost and benefits related to working capital strategies. 81

24) Mr. Chandra (1997) points out biases in Cash flow estimates and says that as the Cash flow of a capital project is forecasted for future. Enough care must be taken to prevent over prediction or under prediction of the profitability of the project. He mentions many reasons for such biases and suggests some points for more accuracy in predictions. 82

26) Mr. Ghosh (1997) believes that some deficiencies are noticed in Cash flow statements. Institute of Chartered Accountants of India and the Securities and Exchange Board of India (SEBI) have issued

81 Ibid., p. 405.
guidelines. To improve Cash flow statement following suggestions have been made:

a) To modify the definition of cash and cash equivalents,
b) Only risk free securities with a maturity period of 90 days or less should be considered as cash equivalent and not all short-term investments,
c) To standardize items which must be disclosed in operating Cash flow,
d) Classify interest and dividend payments in each three categories according to origin,
e) Tax payment or refund must be separately shown according of its effect in the related category,
f) Cash flow related to extra ordinary items should be put in separate section, not separate under each category,
g) Enough disclosure for foreign currency stock and its valuation after adjustment must be done on Cash flow statement,
h) Reconsider the paragraphs 41-42 of SEBI guidelines that have applicability in India,
i) Non-cash investing and financing transactions should be disclosed because it is necessary for predicting future operating Cash flows,
j) Two different methods (direct and indirect) for determining the operating results need a linkage,
k) Emphasise on direct method for calculating operating Cash flows,
l) A separate format for disclosure of operating Cash flows should be suggested,
m) Cash earnings per share should be disclosed in the Cash flow statement. 83