THE CASH-FLOW STATEMENT – BETWEEN TRUE AND MANIPULATION

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ABSTRACT: *Financial statements aim is to assure an efficient dialogue between the company and the external operators interested in having a good perspective of the entity. Information about the cash flows, as component of financial statements, is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilize those cash flows. The objective of our paper is to present the main informational valences of cash-flow statement for investors and also to show the potential "make-up actions" made to give wrong information about a company for the decision makers. For this purpose we will use a research methodology based on a research study by questionnaire on a sample of small and medium enterprises.*

KEYWORDS: *cash-flow, financial statements, decisions, manipulation*

1. INTRODUCTION

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements should be understandable, relevant, reliable and comparable. Reported assets, liabilities and equity are directly related to an organization's financial position. Reported income and expenses are directly related to an organization's financial performance.

Financial statements are intended to be understandable by readers who have "a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently. Financial statements of companies provide a representative overview of a business' financial condition in short and long term. The financial statements present the relevant information of a business company, presented

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in a manner or form easy to understand. There are four basic financial statements presented by all Romanian companies as well like European Union companies: balance sheet, income statement, statement of cash flow, equity statement and a set of notes to the financial statements.

One of the most important components of financial statements is the Cash Flow Statements (CFS). The CFS allows investors to understand how a company's operations are running, where its money is coming from, and how it is being spent. Here you will learn how the CFS is structured and how to use it as part of your analysis of a company. A company can use a cash flow statement to predict future cash flow, which helps with matters in budgeting future activities. For investors, the cash flow reflects a company's financial health: basically is better to have more cash available for business operations. However, this is not a hard and fast rule. Sometimes a negative cash flow results from a company's growth strategy in the form of expanding its operations.

By adjusting earnings, assets and liabilities, the investors can get a very clear picture of what some people consider the most important aspect of a company: how much cash it generates by the company and, particularly, how much of that cash stems from main operations of this enterprise. It seems that every year another top athlete is exposed in a doping scandal. But these are people who are trained since birth to believe that all that matters is their performance, so they naturally take a risk on anything likely to increase their chances of winning. Companies similarly indoctrinated to perform well at all costs, also have a way to inflate or artificially "pump up" their earnings - it's called cash flow manipulation.

Our paper purpose is to present the main informational valences of cash-flow statement for investors and also to show the potential “make-up actions” made to give wrong information about a company for the decision makers.

2. THEORETICAL BACKGROUND

Businesses are all about trade, the exchange of value between two or more parties, and cash is the asset needed for participation in the economic system. For this reason, while some industries are more cash intensive than others, no business can survive in the long run without generating positive cash flow per share for its shareholders. To have a positive cash flow, the company's long-term cash inflows need to exceed its long-term cash outflows. An outflow of cash occurs when a company transfers funds to another party. Such a transfer could be made to pay for suppliers and creditors, employees, or to purchase long-term assets and investments, or even pay for legal expenses and lawsuit settlements. It is important to note that legal transfers of value through debt, like a purchase made on credit, is not recorded as a cash outflow until the money actually leaves the company. A cash inflow is of course the exact opposite; it is any transfer of money that comes into the company's possession. Typically, the majority of a company's cash inflows are from customers, banks and investors who purchase company equity from the company. Occasionally cash flows come from sources like legal settlements or the sale of company real estate or equipment.

Also it’s very important to note the distinction between profit and positive cash flow just because a company is bringing in cash does not mean it is making a profit and vice-versa. For all Romanian companies there are two important parts of a company's financial statements: the balance sheet and the income statement. The balance sheet gives a one-time snapshot of a company's assets and liabilities and the income statement indicates the business's profitability during a certain period. Over that the big enterprises (with more of 50 employees, 7.300.000 euro value of assets or turnover bigger than 3.750.000 euro) have to elaborate other two important parts of financial statements: cash flow statement and statement of changes in equity.

Cash flow statement is determined by looking at three components by which cash enters and leaves a company: core operations, investing and financing. Calculating the cash inflows and outflows caused by core business operations, the operations component of cash flow reflects how much cash is generated from a company's products or services. Generally, changes made in cash depreciation, inventory, accounts receivable and accounts payable are reflected in cash from operations. That’s why cash flow is calculated by making certain adjustments to net income by adding or subtracting differences in revenue, expenses and credit transactions resulting from transactions that occur from one period to the next. These adjustments are made because non-cash items are calculated into net income of companies and total assets and liabilities. So, because not all transactions involve actual cash items, many items have to be re-evaluated when calculating cash flow from operations. That’s why, depreciation which is not really a cash expense; it is an amount that is deducted from the total value of an asset that has previously been accounted for. That is why it is added back into net sales for calculating cash flow. The only time income from an asset is accounted for in CFS calculations is when the asset is sold.

Changes in accounts receivable on the balance sheet from the beginning of the year to the final of the year must also be reflected in cash flow. If accounts receivable increase from one accounting period to the next, the amount of the increase must be deducted from net sales because, although the amounts are considered revenue, not cash. If accounts receivable decreases, this implies that more cash has entered the company from customers paying off their credit accounts.

An increase in inventory, on the other hand, signals that a company has spent more money to purchase more raw materials. If the inventory was paid with cash, the increase in the value of inventory is deducted from net sales. A decrease in inventory would be added to net sales. If inventory was purchased on credit, an increase in accounts payable would occur on the balance sheet, and the amount of the increase from one year to the other would be added to net sales.

The same logic holds true for taxes payable, salaries payable and prepaid insurance. If something has been paid off, then the difference in the value owed from one year to the next has to be subtracted from net income. If there is an amount that is still owed, then any differences will have to be added to net earnings. Cash changes from investing are usually cash out item, because cash is used to buy new equipment, buildings or short-term assets such as marketable securities. However, when a company divests of an asset, the transaction is considered cash from investing.

Changes in debt, loans or dividends are accounted for in cash from financing. Changes in cash from financing are considered cash in when capital is raised, and they're considered cash out when dividends are paid. On the other hand, if a company issues a bond to the public, the company receives cash financing; however, when interest is paid to bondholders, the company is reducing its cash for calculating cash in financing.

Cash flow is often considered to be one of the cleaner figures in the financial statements. Companies benefit from strong cash flow means being more attractive and getting a stronger rating. After all, companies that have to use financing to raise capital, be it debt or equity, can't keep it up without exhausting themselves.

Always we can compare the situation of some companies with an athlete or weight lifter. Every year another top weight lifter is exposed in a doping scandal. But these are people who are trained since birth to believe that all that matters is their performance, so they naturally take a risk on anything likely to increase their chances of winning. Romanian enterprises, similarly indoctrinated to perform well, also have a way to inflate or artificially "pump up" their earnings - it's called cash flow manipulation. Here we look at how it's done, so you are better prepared to identify it.

The corporate muscle that would receive the cash flow accounting injection is operating cash flow (OCF). It is found in the cash flow statement, which comes after the income statement and balance sheet.

Companies can bulk up their statements simply by changing the way they deal with the accounting recognition of their outstanding payments, or their accounts payable. When a company has written a check and sent it to make an outstanding payment, the company should deduct its accounts payable. While the check is on the way, a cash-manipulating company will not deduct the accounts payable with complete honesty and claim the amount in the operating cash flow as cash on hand.

Companies can also get a huge boost by writing all their checks late and using overdrafts. This boost, is a result of how generally accepted accounting principles treat overdrafts: they allow, among other things, for overdrafts to be lumped into accounts payable, which are then added to operating cash flow. This allowance has been seen as a weakness of IFRS, but until the accounting rules change, you'd be wise to scrutinize the numbers and footnotes to catch any such manipulation.

Another way a company might increase operating cash flow is by selling its accounts receivable. The agency buying the accounts receivable pays the company a certain amount of money, and the company passes off to this agency the entitlement to receive the money that customers owe. The company therefore secures the cash from their outstanding receivables sooner than the customers pay for it. The time between sales and collection is shortened, but the company actually receives less money than if it had just waited for the customers to pay. So, it really doesn't make sense for the company to sell its receivables just to receive the cash a little sooner - unless it is having cash troubles, and has a reason to cover up a negative performance in the operating cash flow column. Also a subtle form of increasing operating cash-flow performance is capitalization of expenses.

A company has to spend money to make products. The costs of production come out of net income and therefore operating cash flow. Instead of taking the hit of an expense all at once, companies capitalize the expense, creating an asset on the balance sheet, in order to spread the expense out over time - meaning the company can write off the costs gradually. This type of transaction is still recorded as a negative cash flow on the cash flow statement, but it is important to note that when it is recorded it is classified as a deduction from cash flow from investing activities, not from operating cash flow. Certain types of expenditures - such as purchases of long-term manufacturing equipment - do warrant capitalization because they are a kind of investing activity.

The capitalization is questionable if the expenses are regular production expenses, which are part of the operating cash flow performance of the company. If the regular operating expenses are capitalized, they are recorded not as regular production expenses but as negative cash flows from investment activities. While it is true that the total of these figures - operating cash flow and investing cash flow - remain the same, the operating cash flow seems more muscular than that of companies who deducted their expenses in a timely fashion. Basically, companies engaging in this practice of capitalizing operating expenses are merely juggling an expense out of one column and into another for the purpose of being perceived as a company with strong core operating cash flow. But when a company capitalizes expenses, it can't hide the truth forever. Today's expenses will show up in tomorrow's financial statements, at which time the stock will suffer the consequences.

3. METHODS AND RESULTS

In order to discover and confirm the hypothesis regarding the elaboration and manipulation of cash flow statement, during the year 2009 we performed a survey on a representative sample of 70 companies in Timis County, which in 2008 applied European Accounting Directives.

Based on this survey we received answers from the heads of financial-accounting departments regarding a series of questions about Romania applying the European Directives in the field of financial statements in general and cash flow statement in particular.

The main questions where: Do you elaborate the cash flow statement for the last year? Do you think the fulfil of cash flow statement is useful for your company or not? Which are the main users for your cash flow statement? Which are the main raisons for bad cash flow in your company? Which are the main methods to manipulate the cash flows presented in your financial statements? Do you think the forecast of cash flow statement will be useful for your company?

By these questions we tried to question financial controllers from Timis County about their experience about elaborating and used the cash flow statement in improving managerial performance.

We examined also some particular aspect or technique of manipulate the cash flow presented by Romanian companies.

Based on our survey, we registered the following results:

1. Do you elaborate the cash flow statement for the last year?

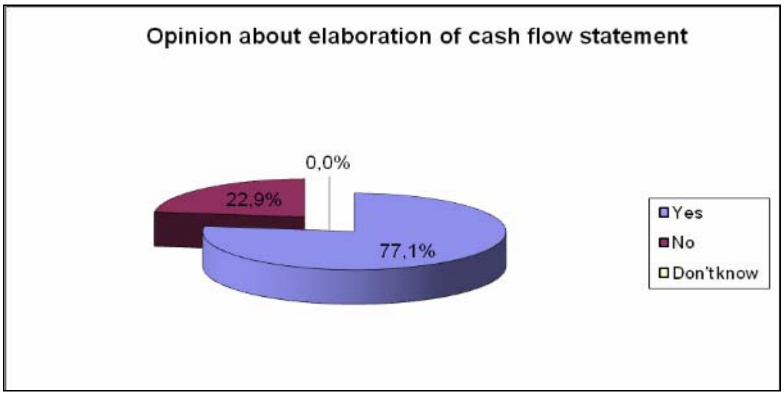

Table 1. Presentation of cash-flow by financial statements

As we can see there are a large number of companies (77%) which elaborate every year the cash flow statement. This sector is represented by large enterprises from Timis County which is obliged by Romanian low to elaborate and present the cash flow statement and a small part of SMEs which are subsidies of multinational companies. A smaller part of respondents (23%) represented by SMEs don't elaborate cash flow statements for their activity because they don't see the advantages of this statement for the future of their company.

2. Do you think the presentation of cash flow statement is useful for your company or not?

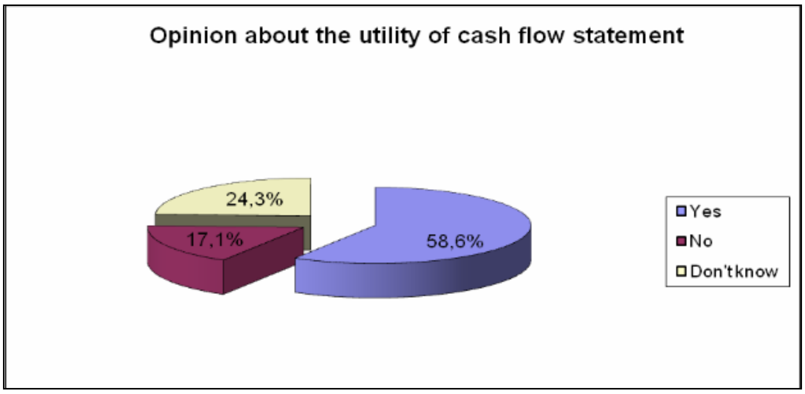

Table 2. The utility of cash flow statement

As we can see from our research almost half from our respondents don't realize the importance of cash flow statement for the good way of their company. The main reason can be the lack of tradition in presentation of this component of financial statements. Romanian companies elaborated cash flow statement since 2001 when Romania applied accounting regulation in compliance with International Accounting Standards. This point of view can be wrong seeing the actual conditions of international financial crisis when the liquidity of companies is very low.

3. Which are the main users for your cash flow statement?

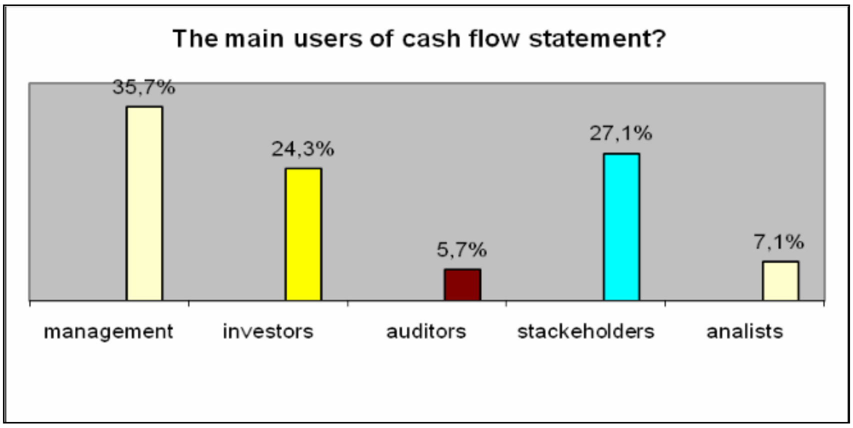

Table 3. Users of cash flow statement

As we can see from our empirical study the main important users of the cash flow statement are the manager's stakeholders and investors.

The managers want to know which the status of the company cash is in order to organize the future payments to suppliers and the future acquisitions or long time investments.

The stakeholders of companies want to see the actual situation of cash-flow in order to evaluate the different ways for the distribution of company's profit.

One of the main index for investors and creditors is the situation of cash-flow. The cash flow information should enable investors to predict the dividends or interest they want to distribute in the future and to evaluate the potential risk of a given investment. The presentation of cash flow is also important to evaluate the liquidity, solvency and financial flexibility of companies. In this way the investors and creditors will make rational decision regarding a company.

4. Which are the main raisons for bad cash flow in your company?

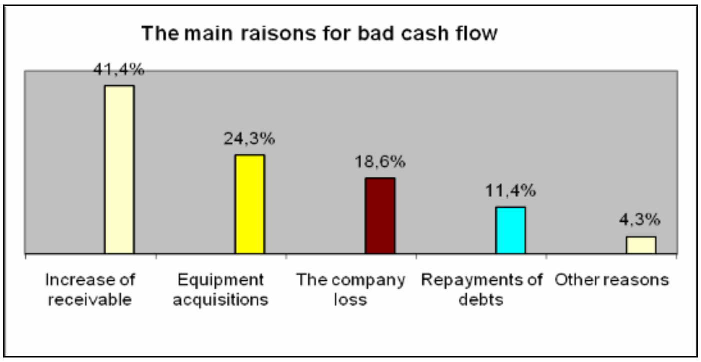

Table 4. Raisons for bad cash flow

The main reason for bad cash flow reported by a company is often represented by the inadequate management of receivables. These problems can also conduct to insolvability or to the fail of companies. For the companies which are in development some periods can show a negative cash flow because of the equipment acquisitions which can be very expensive. But if these equipments are productive in the near future they will generate positive cash flow for these companies. The company loss in crisis periods has also a direct negative influence on cash flow reported by companies and the relation between company loss and negative cash flow is stronger than the relation between the profit and positive cash-flow.

5. Which are the main methods to manipulate the cash flows presented in your financial statements?

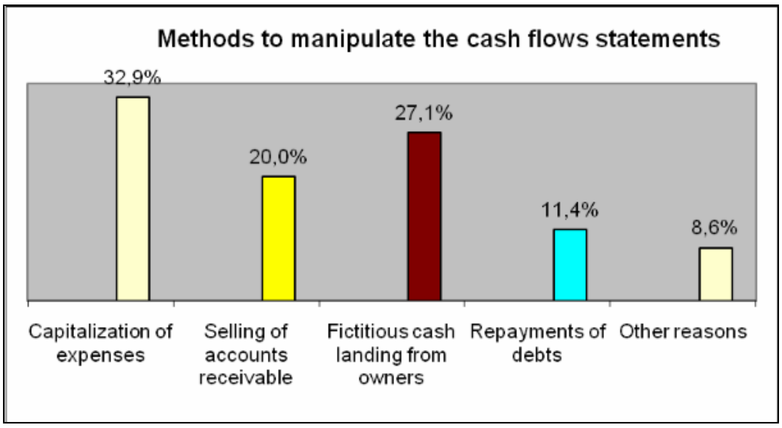

Table 5. Methods to manipulate the cash flows statement

The management of companies whose are on the market to sell wants to provide usually positive cash flow from operating activity. That's why a big number of companies (33%) try to "manage the expenses" and capitalize them in order to transfer cash out from operating activity to investing activity. Also to positives the general cash flow of companies the owners can landing their own company in a fictitious way at the end of the year, in order to report positive cash flow for that financial year.

6. Do you think the forecast of cash flow statement will be useful for your company?

The objective of projections is to make a reasonable forecast of a firm's future cash flow performance and probable financial condition that will allow you to answer questions such as: will the firm be able to pay back its current debt obligations out of future cash flow?, how much additional financing will the firm need to finance its future growth?, what is the firm's future debt capacity?, What is the maximum amount of debt that can be serviced out of cash flow, given the firm's other needs, such as working capital, plant expenditures, and so on?

That's why a big number of companies (63%) answered that the forecast of the cash-flow statement is a very important tool for the decision-makers.

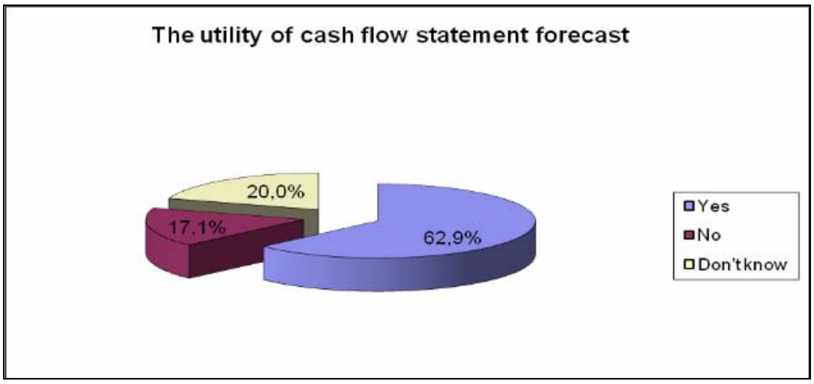

Table 6. The utility of cash flows statement forecast

4. CONCLUSIONS

The advantage of a cash flow statement, when used in conjunction with the rest of the financial statement, is that it provides information that enables users to evaluate the changes in the net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful for assessing the ability of an enterprise to generate cash and cash equivalents and it also enables users to develop models to assess and compare the present value of future cash flows of different entities. It also enhances the comparability of the reporting of operating performance by different entities because it eliminates the effects of applying different accounting criteria for the same transactions and events. Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and for examining the relationship between profitability and net cash flow and the impact of changing prices.

Cash is one of the major lubricants of business activity, but there are certain things that cash flow doesn't tell us. It doesn't tell us *the profit earned or lost* during a particular period: profitability is composed also of things that are not cash based. This is true even for numbers on the cash flow statement like "cash increase from sales minus expenses", which may sound like they are indication of profit but are not.

As it doesn't tell the whole profitability story, cash flow doesn't do a very good job of indicating the overall *financial well-being of the company*. Sure, the statement of cash flow indicates what the company is doing with its cash and where cash is being generated, but these do not reflect the company's entire financial condition. The cash flow statement does not account for liabilities and assets, which are recorded on the balance sheet. Furthermore accounts receivable and accounts payable, each of which can be very large for a company, are also not reflected in the cash flow statement.

On the other hand, the cash flow statement is a compressed version of the company's checkbook that includes a few other items that affect cash, which shows how much the company spent or collected from the repurchase or sale of stock, the amount of issuance or retirement of debt and the amount the company paid out in dividends. Being considered to be one of the cleaner figures in the financial statements cash flow statement is sometime the object of manipulation. Companies try to report big positive cash flow and the benefit from strong cash flow means being more attractive and getting a stronger rating. After all, companies that have to use financing to raise capital, be it debt or equity, can't keep it up without exhausting themselves.

Respected financial professionals, demonstrate that it's a lot harder to manipulate cash flow from operations than it is earnings per share, but the interest of management can be very strong in that manners to "make-up" other face for their company.

Over all cash flow statement is very necessary for decision makers because it measures the actual money paid out or received by a company over a certain period of time. This measure excludes non-cash accounting charges like depreciation. And, more importantly, cash flows are objective. There is no value judgment about when and how revenues are recognized, the cash flow statement only recognizes the actual cash that passes into or out of a business. To this point we have looked at past and present performance, evaluating existing financial statements and existing cash flows. In our days it is time to look to the future. Forecasting cash flows is notoriously difficult, but it is still an extremely valuable exercise to prepare a prediction of what a company's financial statements may look like in the future in order to prepare the competition with the concurrence.

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