Analysis Of Cash Flow Statement: Review Of Literature

1 Meaning of Review of Literature:

A literature review is an evaluative report of studies found in the literature related to your selected area. The review should describe, summarize, evaluate and clarify this literature. It should give a theoretical basis for the research and help you determine the nature of your own research.

A literature review is a scholarly paper, which includes the current knowledge including substantive findings, as well as theoretical and methodological contributions to a particular topic. Literature reviews are secondary sources, and do not report new or original experimental work.

2. Review of Literature:

1. Aghdas Jafari Motlagh, (2013):

According to him in his study about how statement of cash flow is prepared and how it is differentiated from fund flow statement. They make use of secondary data collected from various websites, journals, etc. The study concluded that funds flow statement is not much useful in short term financial planning like cash flow statement because the cash is more important to execute the plan in short run as compared to working capital.

2. Thomas Zeeker and Brian Stanko, (1990's)

This study is based on retail sellers and analysed whether the cash flow ratio is useful for the financial ratio analysis. With the help of primary data they found that the cash flow statement for retail sellers is useful to find out the financial ratios. Apart from this they also found that in order to assess the economic status or financial position of retail firm not only accrual basis of accounting but also the new and traditional accounting methods should be implemented.

3. Ajay Paliwal, Mukesh Ahirrao and Rana, (2015):

According to them, to analyse the financial performance of a firm cash flow statement is an important tool and the cash flow changes can be identified only by making comparison of the financial position of a firm for at least two years. The study found the net changes in cash and its distribution in financing, investing, and operating activities which helps to measure strength and weakness in cash flow statement.

4. Jeffrey Hales and Steven Orpurt, (2013) :

The study is on significance of direct method and indirect method of cash flow statement to financial statement users. They concluded that the direct method information is economically significant and that the recurring benefits that many firms derive from providing direct method information likely exceed recurring cost.

5. Finger (1994):

Conducted a study to test a firm’s specific predictive ability for future cash flow over the entire time period by using a time series model. For this Annual data for the 50 sample firms starting from the year 1935 to 1987 was obtained from Compustat annual industrial file from 1968 to 1987 and supplemented with hand gathered Annual Report information from 1935 to 1967. Those firms were members of the 1988 fortune 500. Cash flows from operations were approximated by adjusting income before extraordinary items for depreciation, deferred taxes, changes in non-cash current assets, and changes in current liabilities excluding current maturities of long term debt. Earnings were represented by net income before the spending on some extraordinary items.

He concluded that earnings used either alone or together with cash flow, were an important predictor of future cash flows. However, the results revealed that current cash flows were a superior predictor of future cash flows compared with current earnings for short term prediction.

6. Plewa and friedlod (1995):

Analysed that the cash flow prediction can help companies to know about cash position and make its expenditures needs accordingly such as for acquisitions and payment of expenses. Therefore, difference between future cash flow and actual cash flow is necessary for analysing, understanding and measuring a firm’s performance.

7. Cheung, Krishnan, and Min (1997) :

Aims to study the relationship between deferred income tax and future operating cash flows and tax payment. Investigate the incremental information of deferred income tax; first, they tested the ability of deferred tax to predict future tax payment, and predicted future operating cash flows. They examined the predictive ability by adding the deferred tax variable into model. In their study, operating cash flows are an independent variable, and were calculated by operating income before depreciation, minus interest expense, current portion of income tax expense and increase in net working capital other than cash and securities, net of short-term debt. This test showed that the addition of the deferred tax variable improves the prediction of future cash flow. In particular, it is more useful if companies have large amounts of deferred tax.

8. Wallace, Choudhury and Pendledury (1997) :

Analysed that the use of the cash flow for any enterprises derived from investing activities and also the settlement of outstanding financial obligations in a financial period is from internal and external resources. Internal sources are derived from net cash generated from current operations. External sources come out from financing activity such as borrowing and receiving cash from sale activities and equity shares.

9. Dyna Seng (1997) :

In the study they examined the predictive ability of earnings and reported cash flow measures CFFO, Cash Flow from Investing Activities (CFFIA), and Cash Flow from Financing Activities (CFFFA) to forecast one and two-period ahead cash flows during the period 1989-92, The degree of relationship between earnings and cash flow measures is also examined as a secondary goal of the study. The results provide evidence that CFFO, CFFIA is a better predictor of one- and two-period ahead CFFO; CFFIA than is earnings and CFFFA is a better predictor of two-period ahead CFFFA than is earnings. Whereas, my study focuses on ability cash flow from operation activity as predictor on future cash flow and not mention about CFFIA and CFFFA.

10. Patricia M. Dechow and et. al (1997)

Made an attempt to examine a simple model of earnings, cash flows and accruals is developed by assuming a random walk sales process, variable and fixed costs, accounts receivable and payable, and inventory and applying the accounting process. The model implies earnings better predict future operating cash flows than the current operating cash flows and the difference varies with the operating cash cycle. Also, the model is used to predict serial and cross correlations of each firm's series.

11. Wang and Eichenseher (1998)

They analysed earnings under accounting could themselves suffer from timing and matching problems that may contribute to errors in assessment of a firm s value In some cases, accruals may include poorly estimated receivable collections, depreciation, equity method income that does not approximate market changes, and current recognition of previous periods, increases in market value.

As a result, under these circumstances accrual earning may be less effective in their ability to predict future cash flows, and users of accounting information turn to consider cash flow instead.

12. Mossman et al (1998) :

They have found that the relative usefulness of cash flow versus accrual data in providing information to decision makers has been examined in many contexts, such as relevance to stock prices, insolvency and bankruptcy. It suggested that cash flows can be used as an early warning of potential financial distress.

13. Lee, Ingram and Howard (1999)

Conducted a study on the difference between earnings and cash flow from operations. It can be used as an important signal of potentially fraudulent financial reporting those auditors and other analysts should consider, in addition to other factors such as leverage, retained earnings and market value. The excess of earning over cash flows indicates the fraud risk in the coming years. This is because the fraudulent firms often have poor financial performance but they conceal their performance by overstating earning.

14. Brighm and Gappenski (1999):

found out in internal capital investment, capital budget analysis also involves cash flow prediction. The capital investment deals with investment projects such as new product, replacement of existing asset, or expansion of product lines. The projects can be evaluated by various methods including net present value NPV and Internal Rate of Return, (IRR).

15. Dana Aollie (1999):

Provided evidence that A) cash flow components reflect different information related to future cash flow B) The disaggregation of cash flow components has the potential to enhance prediction model performance. He finds that other factors of cash flow such as sales, cost of goods sold, operating expense, and interest have similar persistence in predicting future cash flows. He clears that cash flow components and accrual components complement each other in explaining future cash flow. His findings are usually from several perspectives, and his results provide a benchmark for the importance of the details of cash flow in predicting future cash flows. His finding also provide a basis for policy makers in evaluating the reporting of line items for operating cash flow, and his findings are based on estimation, it include special items and may still include core cash flow components.

16. John Wileyand Sons (2000)

discovered operating activities in every company are the main activities and include revenue producing and other activities that are not investing and financing activities. Investing activities include the acquisition and disposal of long term assets and other investment except short term investments. Financing activities constitute changing of result in the size and composition of the equity capital and the borrowing of the enterprises.

The accrual accounting is a basic accounting assumption dealing with the accounting process of recognizing the effects of financial transactions in the period in which events occur, rather than focusing only on cash receipts or payment.

17. Gallinger (2000):

evaluated, cash flow from operations activity can be evaluating the quality of profits on income statements. The difference between net cash flow from operation and net profit is the helpful in interpreting the quality of earning. A large difference between net profits and cash flow from operation will reflect a low quality of profits- perhaps net income has increased without an increase in cash flows from operations. This may result from increases in sales on credit, causing increases in accounting receivable, indicating that the company may have a cash collection problem in the future.

18. Boyd and Cortese Danile (2000)

In their study they reported cash flow from operations is often seen as the most important category among the three categories because it results from the main income producing activity. Cash generated from the operating activity provides an indication of the company to produce cash from its main activity. The company must generate sufficient cash from its operating activities to finance its daily activities (Boyd and Cortese- Danile 2000- 2001). Moreover cash flow from operations primarily supports capital expenditures and dividends (Grossmanand Pearl 1988).

If the company cannot generate any cash to repay loan, pay dividend or make new investment, the company would lend cash from external sources, causing future cash flows.

19. Lee and Leibman at el (2000):

Conducted the study by using cash flow from operations to calculate free cash flow. Free cash flow is money earned from operations after giving provision for capital expenditure at the end of an accounting period. It is basically defined as net cash flow from operation activity, less capital expenditures and dividend on preferred stock. It shows the ability of the company to generate cash from its operations after spending money on the expenditure.

20. Henderson and Peirson (2000):

In their study they reported the accrual concept recognizes assets, liabilities, revenues and expenses to record the trade transactions, including cash and credit transactions. An asset refers to a resource that belongs to the company as a result of past financial transactions IASC (2000). Assets represent future benefits including cash that is expected in the future. They can be divided into two categories according to their longevity, current and noncurrent assets. In addition to cash, current assets include accounts receivable, inventories, prepayments and other assets that will be converted into cash within twelve months of the reporting date. In contrast, noncurrent assets refer to assets that will not be converted into cash within next twelve months after the end of the financial year, such as land and buildings, plant and equipment and intangible assets, including goodwill.

21. Kimmel, Weygant and Kieso (2000) :

Concluded that cash flow statement is an important and necessary principle of perfect financial reporting by national and international accounting standard board, because financial statement users note that the balance sheet, income statement and retained earnings statement do not always show the whole financial condition of a company.

22. Zwaig and Pickett (2001):

Predicted that creditors, lending decision, predicting bankruptcy problems of a customer can prevent losses due to bad debts. There are a number of early warning signs indicating that a company is experiencing financial distress. Cash flow is an important financial indicator of a financial problem.