Journal of Management Matters Volume 2 Number 1-September 2015

Management Matters
Faculty Journal Faculty of Management Matters
Journal homepage: WWW.rjt.ac.lk/faculty

Faculty of Management Studies

Cash Flows and Firm Performance: Some Evidence from the Sri Lankan Firms Cash Flow

Wijewaradana W.P[1], Munasinghe P.G[2]
Department of Accountancy and Finance[1], Department of Business Information Technology[2], Faculty of Management Studies, Rajarata University of Sri Lanka, Mihintale, Sri Lanka
percywpv@yahoo.com

Abstract

This study investigates the consequences cash flows and their impact on business financial success under firm's stability, liquidity and profitability which show the investment and its final outcomes. Three different consequences from stability, liquidity and profitability related paradigm are anticipated firm financial strategy, accounting and financial misconduct and investment consequences. These are in the business context found to practice from different strategy. Among the firm strategy, cost leadership heavily affect the strong positive cash flows. On the other hand differentiation strategy faces longer investment consequences and greater stability and liquidity of cash flows. Nevertheless, the investment consequence was ephemeral for any strategy. However portal point is sufficient cash flow need to be generating within the business unit. In the cost leadership or differentiate urged to fulfill investment criterion.

Keywords: *Business performance, Cash flow, Cost leadership, Differentiation, Liquidity, Stability*

1. Introduction

At present context of the firm's main purpose is earning profit by increasing firm performance. Most of the business competitors have today in new business environment result of turbulent environment. It is competitive and controversial. Therefore business entities develop and introduce strategies for compete the market. Business entities use new methods for analyze information based on the decision making. As well as most of the business entities engaged in different financial activities to face competitors strategy. In recent years, the cash flows statement has come to view as part of financial statements and important device for interest parties to collected the financial data. The conceptual framework for preparation and presentation of financial statements came to play important role after involvement to prepare and presentation of financial statements after introduce new sectional statement and need for new requirements. On the hand regulatory framework includes government legislations, accounting standards, security exchange regulations and tax rules (Wijewardana and Lakmali, 2013). All of the business entities devotion to most suitable ways that can be achieved their financial requirements. Azarberahman, (2013) stated that business entities get most of the decisions based on their financial statement rather that other information. Most of the business entities prepare cash flow statement to use for financial management as internal information source at the previous years (Ahmed and Jahangir Ali, 2011). Objectives of cash flow statement are to produce information to assess the timing, amount and predictability of future cash flows it versatile to predict future certainty, and it can basis for budgeting. The cash flow statement's primary purpose is to provide information regarding a company's cash receipts and cash payment in varies sources. A secondary purpose of the cash flow statement is to provide information about a company's operating, investing, and financing activities (Bhandari and Iyer ,2013). Further, Cash flow is one measurement for evaluating firm stability, strength, and future ability to generate cash flows but it is useful to focus on actual operations and eliminate non- cash charges. Cash flow is one of the most important measurements of used by investors in valuing a company and Cash flows are best window for investment (Maxwell Samuel Amuzu, 2010). Cash flow is not the same as net income. It is completely different from Cash flow is the movement of money into and out of company, it can be affected by several non-cash transaction. Cash flow statement mainly represents three main categories generating cash from operating, investment, financial activities. The Statement of Cash flows in accordance with the requirements of Sri Lanaka Accounting Standards (LKAS) 7 and it provides information about the Cash flows of an entity useful to generate cash & cash equivalent and the needs of entity to utilize those cash flows (LKAS 7, Statement of cash flow).

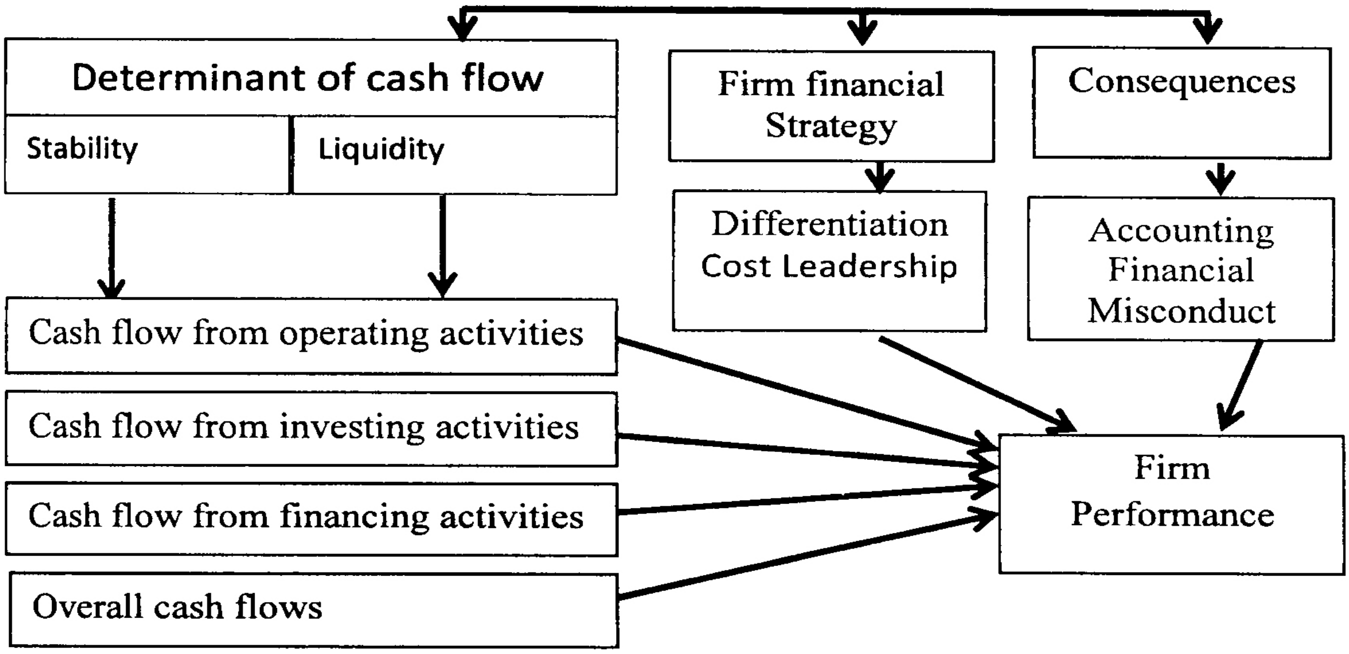
2. Problem Statement

Cash flows and firm's performance are measured by return on assets (ROA) and return on equity (ROE) is most significant information for company to achieve company goals and objectives. Cash flow statement includes short term cash inflows and cash out flows. This information shows the company present situation and ability to generate future cash flows which imply company risk and return generating strength. Companies' external & internal parties can evaluate firm's performance by using cash flows information. The research is intended to identify the impact of Cash flows and Firm performance. All Companies get dominant the information hazard in order to take better decision on their business. In this environment assess the future ability is challengeable. Hence, providing information from cash flows implies company finance related symptoms such as Solvency, Profitability and Operations information which is most important factors to the management to get their decisions to achieve the company performance. This study mainly focuses to examine the performance related issues that help to scan every aspect in business success. This study attempts to examine the outcomes of business performance and development of intensity and impact of cash flow on business performance. The complexity of the relationship between business performance and cash flow ability is revealed in part by finding reciprocal effects, stability of performance spending over time and accounting information linkages as cash flows must be interested. A more accurate understanding of the relationship of company performance and cash flow needs to simultaneously consider this study.

3. Conceptual Development

The Conceptual framework for cash flow and firm performance is depicted in **figure 1**. Cash flow is shown as having these types of outcomes that influence company performance and are moderated by strategy. Further, performance may have liquidity effect on subsequent cash flow intensity along with stability relationship whereby previous cash flow exhibiting sub parts influence subsequent levels.

Figure 1: A conceptual framework



Source: Author, 2015

Strategy

Business level performance related strategy formulation involves purposive action to align the company with a highly competitive business environment (Ansof, 1984; Chamberlain, 1968), with firm success depending upon the ability to achieve competitive advantages (Porter, 1985). Business innovation has been a major dimension in cost conceptual typologies of generic strategies. Among these strategies, there is general agreement on two profitable and defensible strategies: cost leadership and low cost.

Accounting Consequences

Accounting Consequences occur in the same accounting period as cash flow hence, current accounting guidelines dictate that such allocations are to be expensed expensive. Because of the income statement linkage, stability in future cash flows are accompanied by matching instability in pretax net income. Similarly, this linkage will cause stability in cash flows intensity to result in matching instability in company performance. This particular relationship will be the same regardless of strategy and implication suggests the following hypothesis.

H_2: More value seeking cost Leader Company would have more performance than the other firms. Consequently, the effects of stable and efficient cash flow intensity on firm performance will be greater than instable and inefficient cash flows company.

Disruptive Consequences

Disruptive Consequences result from costly changes that the firm implementation the enhancements of the company performance. Further, this may root business units to revert to a higher part of the business life cycle. Such disruptive consequences are not confined to business, but may force through downstream activities, thereby depressing profitability in the current period and proximal lagged periods. Business strategy will influence the magnitude and duration of disruptive effects. In business development strategy context it should be included product differentiation, uniqueness may be either in the form of tangible or real embodiments, or may be perceptual. More likely, however, differentiation will consist of business strategic package involving product and other value adding business strategy. In cost leadership business strategy, disruptions will be centered more on production, as is evidenced by the strong association of the business life cycle with production specific phenomena. With less prominence on instable business activities, there will be fewer disruptive effects. Further, the propensity to cost leaders business strategies to undertake smaller, more incremental changes in their current business offerings would expedite product introduction. This empirical implication suggests the following hypothesis.

H_2: The disruptive consequences associated with business cash flows will be established more rapidly in business pursuing a cost leadership business strategy than in business pursuing a differentiation business that may be ensued less business performance.

Investment Consequences

The evident properties of cash flow on firm performance over time have been the focus to efficient investment. Many empirical research points to positive consequences of cash flows on business performance, yet researchers have not measured for multiple types of consequences or examined the moderating influences of business strategy. The ultimate objective of strengthening the cash flow is usually to realize future improvement of stability, liquidity and profitability through unique business performance attributes. Although it is generally assumed that these returns will extend well into the future, this may be not realized. First, their sustainability must be grounded in competitive advantage rather than business enhancement. Second, current accounting practices that require expending all cash flows suggests that the substance of cash flows spending does not have the attributes of an investment. Moreover, attenuated investment consequences will be particularly pronounced at the business level where cash flow is more applied than its corporate level counterpart. This consequence suggests the following hypothesis.

H_3: The investment effects from cash flows will dissipate rapidly in both strategies. This may influence heavily in downturn of business performance.

Relative to cost conduct leaders, cash flows in differentiated business will involve greater changes that need more involved downstream coordination (Ryals, 2005). These characteristics would mean that the onset of observable consequences from changes in cash flows intensity on Business performance (ROE and ROA) will be more retarded and have a greater duration. It is hypothesized that:

H_4: The net positive consequences from cash flows intensity on profitability will extend farther into the future in business pursuing a differentiation strategy than for business performance pursuing a costs leadership strategy.

Stability, Liquidity and Profitability

As figure 1 show, this requires the inclusion of (a) a stability relationship, where cash flows spending is influenced by levels in the previous period, (b) a liquidity relationship, where financial performance leads to an availability of internal funds for increased cash flows, and (c) Profitability is combined results and success of the stability and liquidity of cash flow that impact on overall signals of the business performance. The liquidity relationship resulted from a support on decision heuristics based on past financial performance for funding. Due to the high levels of uncertainty associated with cash flows, it is common to adjust the cash flows based on certain rules of thumb, in practically on guideline being the past cash flows level. Assuming that, this effect is more noticeable near a threshold where marginally performing business face difficult long term and short term tradeoffs. Stability replicates the needs for cash flows to be consistent through funding period. Uncertainties of cash flows proposals and progress require enduring funding. Consequent, stability refers the current level of funding is expected to be greatly influence by the level of funding in the past period.

4. Method

Homogeneous sample reflecting the study objectives were drawn from audited financial statements published by Colombo Security Exchange (CSE) which contain 37 manufacturing companies selected for sample among all 19 sectors based on year 2011. CSE that had reported data for 3 years and total data observation was extracted 107 (n=107). Eliminating certain features are well suited to this study: (a) annual observations over a sufficient time period; (b) distinction between cash flow indicators and business performance indicators; (c) performance analysis; (d)pretax and aft tax measure o ROA and ROE, (e) Sufficient number of observations. Descriptive statistics such as mean and standard deviation will perform to assess behavior of study variables and to examine the association among the cash flow measurements and business performance, the study performs the correlation analysis. To test the statistical significance of the observed differences in the mean business performance across the cash flows, the study performs a statistical analysis of variance (ANOVA) using variables. The examination of the impact of cash flows on company performance and their hypothesized determinants tests regression models which is formulated as follows;

$$\textit{Model } 1 \quad ROA = \alpha + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \lambda$$

$$\textit{Model } 2 \quad ROE = \alpha + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \lambda$$

Where ROA and ROI is a dependent variables, α is intercept coefficient of independent variables is equals to β and X denotes independent variables. Independent cash flow variables are Operating activity (OA), Investment activities (IA), Financing activities (FA), and Overall Cash flows (OC).

5. Results and Analysis

Table 1 presents the descriptive statistics for the sample companies. The average ROA and AOE are 11% and 9.7% respectively in the manufacturing industry. The average cash flows by the OA, IA, FA and OC has been reported Rs 26000000, Rs -13000000, Rs -5700000 and 7400000 respectively. Variation of all the cash flows is very high based on the reported standard deviation. Further, variation is reported 12% from ROE it is less compared to the ROA.

Table 1: Descriptive Statistic

Variables	**Mean**	**Std. Deviation**
OA	2.58E8	6.506E8
IA	-1.27E8	4.261E8
FA	-5.70E7	5.087E8
OC	7.41E7	4.678E8
ROA	0.1130	0.3941
ROE	0.0979	0.1232

Source: Data Analysis, 2015

Table 2 exhibits the correlation matrices for the regression models. Among the regression variables, FA statistically correlated with negatively on OA and IA but OC statistically positive correlation reported with OA and IA. As a dependent variable ROA statistically positive correlation has reported with OA, negatively correlated with FA. Finally, ROA is positive and significantly correlated with ROE.

Table 2: Correlations Metrics

	OA	**IA**	**FA**	**OC**	**ROE**	**ROA**
OA	1					
IA	-0.136	1				
FA	-0.710**	-0.229*	1			
OC	0.495**	0.472**	-0.108	1		
ROE	0.140	-0.014	-0.118	0.053	1	
ROA	0.413**	-0.056	-0.374**	0.116	0.266**	1

**. Correlation is significant at the 0.01 level (2-tailed). *. At the 0.05 level (2-tailed).

Data Analysis, 2015

Results from the model 1 and 2 appear in table 3. The researcher run two models to most clearly illustrate the effect of cash flows on company performance in manufacturing companies traded in CSE. Model 1 and 2 has been regressed on four independent variables with ROA and ROE.

Table 3 Regression Results

$$Model\,1 \quad ROA = \alpha + \beta_1 OA + \beta_2 IA + \beta_3 FA + \beta_4 OC + \lambda$$

$$Model\,2 \quad ROE = \alpha + \beta_1 OA + \beta_2 IA + \beta_3 FA + \beta_4 OC + \lambda$$

Variables	*Model 1*		*Model 2*	
	Coefficient	**p-Value**	**Coefficient**	**p-Value**
Constant	0.0810	0.0000	0.0930	0.0000
OA	Exclude	Exclude	Exclude	Exclude
IA	-6.827E-11	0.0240	-7.348E-11	0.4840
FA	-9.899E-11	0.0000	-9.940E-11	0.2030
OC	4.825E-11	0.0720	6.456E-11	0.4900
R^2	0.1870		0.0200	
ANOVA Sig	0.0000		0.5460	

It is noted that model fitness value is represented less value and indicate that the fitness is not suitable to predict the population. It compares the adjusted R^2 from the two models to determine whether the R^2 from the model 1 is significantly higher than adjusted R^2 from model 2. Model 1 which regresses ROA on independent variables derived from the surviving literature, is significant 5 percent level and adjusted R^2 is 0.1870. As expected, several of the variables are negatively associated with ROA (IA and FA). The coefficient for OC is positively insignificant.

Model 2 regress AOE on four independent variables derived from existing literature and the three test variables of interest. The adjusted R^2 for model 2 is 0.020. There are insignificant negative relation among the ROE and IA and FA. The insignificant positive coefficient of the OC suggests the possibility of cash flow of companies caused by the company performance by means of return on equity. To test the hypotheses, study conducted multiple linear regression modeling analysis in which sample was entered in systematic manner. The first hypothesis (H_1) is predicted that the business cash flow effect would not occur more rapidly in the business performance although the concurrent ROA due to decrease in investment activity and financing activities intensity comprises all strategy as mention earlier, these can be disaggregated. The second hypothesis (H_2) which anticipated a rapid dissipation of positive consequence in both strategies is supported. This is evidenced by the investment and financing cash flows. Third hypothesis (H_3) the net cash flow positive consequence would extend father into the future performance. In both models OC cash flows influence not significantly impact on the business performance, which reported third hypothesis was rejected.

6. Conclusion

This paper examined the cash flows and firm performance using data from the manufacturing sector for the period 2011 to 2013. Study findings suggest that cash flow statement decisions have various implications and more rigorous, not seen clear indication in relation to the firm performance which among other factors influence the value of the firm. The most striking finding in this study is the operating cash flow not supported with both business performance indicators. Because first step operating activity cash flow are excluded in analysis. Thus, this study supports statements that investment and financing cash flow comprises quite incremental, routing investment modification in the business that are costly to introduce and may be readily responded to by the competition and at present all the market demand has been shrinking. This study analyses the relationship between cash flow and company performance, using a manufacturing sector. It is argued that private sector manufacturing companies may be characterized by highly stability and efficient industry. According to the business paradigm based prediction, such higher stability and efficient industry should lead to higher demand for cash flow and, stability and efficient, and subsequently result in higher performance. On the other hand argued, that if the firm is stable and efficient, performance in a firm with sufficient cash flow would have better business strategy to have higher performance their normative behavior. This results shows that the cash flow statement have not remarkable significant relationship ROE as a performance indicator but investment and financing cash flow activities have significant negative relationship with performance as ROA. Finally, the virtual absence of liquidity effects and the high levels of stability found in this study but not statistically significant.

Reference

Ahmed, K., and Jahangir Ali, M.(2013). Determinants and usefulness of analysts 'cash flow forecasts: Evidence from Australia. Accounting and Information Management, 4-21.

Ansof, H.I.1984. Implanting strategic management. Englewood Cliffs, NJ: Prentice Hall.

Azarberahman, A. (2013). The association between various earnings and cash flow measures of firm performance and stock return: Some Iranian evidence. Accounting and Finance, 24-41.

Bhandari, S. B. and Iyer, R. (2013). Predicting business failure using cash flow based, Accounting and Finance.

Chamberlain,N.W (1968). Enterprise and environment: The firm in time and place. New York: McGraw-Hill.

International Accounting Standard. IAS 7, CASL.

Porter,M.E. (1985). Competitive advantage: Creating and sustain superior performance: New York: The Free Press.

Ryals, L.(2005). Making customer relationship management work: The measurement of customer relationships, journal of marketing. 69(4), 252-261.

Sri Lanka Accounting Standard (LKAS) 7, CASL.

Wijewardana W.P and Lakmali P.L.A.Y A (2013). A study of the disclosure level of cash flow statement- Rajarata University Journal Volume :1 Number 1 December 2013, 22-26.