

Examining Free Cash Flow To Manage A Company's Financial Flexibility

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Abstract-- Cash management may become a factor that affects a company's profitability. A high amount of cash will result in idle cash that decreases the company's ability to generate optimal returns, while the low amount of cash may result in losing the opportunity to meet its obligations. This research uses a quantitative-descriptive analysis. Of the 10 financial report SME's surveyed in 2010, only five companies are able meet the basic needs of their capital expenditures incurred dividend paid; while four companies are not even able

to meet the primary needs because it generates negative free cash flow, and one company unable to meet the free cash flow in 2010. All companies are advised to count and prepare cash flow report as well as free cash flow reports by themselves so they can decide on the amount of cash that should be held in the balance sheet.

Keywords-- Cash Flow; Free Cash Flow; Cash Management

I. INTRODUCTION

A good financial condition is one requirement that must be considered in improving a company's business capability and business competition. One way is to analyze the amount of cash balance that should be owned by company. Cash measures the financial health of a company that can used by the users or shareholders to make decisions relating to the company. The company that has too much (excess of) cash is considered unsatisfactorily to its shareholders. While the company that has a shortage in cash will result in losses for not being able to meet all cash needs for the main activities. Cash is also a decisive element of liquidity, solvency, as well as the flexibility of the company.

This research was conducted to test the amount of corporate cash balances compared to the free cash flow that should be there. The differences will be analyzed through a hypothesis to be tested by using a statistical model pair sample T-test to see if the difference is significant or not. If the difference is significant, the differences of information concerning the health condition of the company will affect the decision of users who use the information.

II. CASH MANAGEMENT

Cash is the most liquid assets of companies, because cash is the medium of exchange. Cash is very easily

concealed and easily stolen. As a result, most companies create adequate control and management for cash (Hongren, et al., 2007, p.397)

SFAC No.5, FASB contains an opinion of Statement of Cash Flow, as follows :

"It provides useful information about an entity's activities in generating cash through operations to repay debt, distribute dividend, or reinvest to maintain or expand operating capacity; about its financing activities, both debt and equity; and about its investing or spending of cash."

This mean that, the statement of cash flows provides useful information regarding the company's activities in generating cash through operations to repay debt, distribute dividends, and reinvest to maintain or expand the operating capacity. Financing activities include debt and equity, and the company's investment activities or spending cash. Statements of cash flows are often used by the creditor to check a company's ability to repay the loan. A good starting point in the examination is to find net cash provided by operating activities.

The creditors will use the Statement of Cash Flow to answer several of the following questions: (i) *How do companies generate net cash provided by operating activities?* (ii) *What is the trend in net cash flows provided by operating activities from time to time?* (iii) *What are the main causes of the negative or*

positive cash flow provided by operating activities? (Kieso, et. al, 2001, p.242)

Free Cash Flow (FCF) analysis is a method that can be used to examine a company's financial flexibility. This analysis begins with net cash provided by operating activities and free cash flow ended (free cash flow), which is calculated as net cash provided by operating activities deducted by capital expenditures and dividends. Free cash flow as defined by Kieso, et. al, is the amount of discretionary cash flow a company to purchase additional investments, paying off debt, purchasing treasury stock, or raise liquidity. The amount may indicate the level of financial flexibility. (Kieso, et. al, 2001, p.243-244)

The definition of Free Cash Flow by Jensen (1986) is the cash left over after all the projects that generate positive *net present value* discounted at the relevant *cost of capital*. White, et. al. (2003) define free cash flow as cash flow available for discretionary companies. Free cash flow is cash from operating activities deducted by capital expenditures spent on the company to meet current production capacity. According to Ross, et. al. (2000), free cash flow is the cash flow that can be distributed to the company's creditors or shareholders who are not used to working capital or investment in fixed assets.

Several questions answered by the analysis of free cash flow are : (a) *Is the company able to pay dividends without using external financing?* (b) *If the business operations are down, is the company able to sustain the capital investment required?* (c) *How much free cash flow can be used to make additional investments, pay off debt, buy treasury shares, or increase liquidity?* (Kieso, et. al, 2001, p.244).

Free cash flow could be calculated by the following formula :

$$FCF = (\text{Net Cash from Operating Activities} - \text{Deviden}) / \text{Total Assets, or,}$$

$$FCF = \text{Net Income} + \text{Depreciation (Amortization)} - \text{Changes in Working Capital} - \text{Capital Expenditures,}$$

or,

$$FCF = \text{Net Cash from Operating Activities} - \text{Capital Expenditures}$$

III. METHODOLOGY

This research was conducted using the quantitative-descriptive method. The first step is to collect all data (business profile and financial statement) from ten companies that become the object of research, in order to obtain the company's financial picture. Second comes is calculating the cash flow and free cash flow. The third step and the last step, is make some analysis and drawn conclusions based on the comparison data obtained by the company and the amount of calculation from the theory of Cash Flow and Free Cash Flow.

Companies come from small and medium scale of business around West Java, Indonesia, that have been selected as the object of study as follows:

	Company Name	Location (City)
01	APT. M	Bandung
02	PT. IDM	Bandung
03	PT. ABP	Bandung
04	PT. SI	Jakarta
05	CV. BB	Jakarta
06	PT. BI	Bandung
07	PT. Jty	Bandung
08	CV. FS	Bandung
09	PT. TA	Bandung
10	PT. SanIn	Bandung

(Sources : Meliala T., Elizabeth T.M., Francisca, *Free Cash Flow Report for LPPM UNPAR, 2012*)

IV. CALCULATING AND REPORTING CASH FLOW

The ten companies that have been observed are described as follows :

No	Company Name	Scope of Business	Amount of Sales & Number of Employees
01	APT. M	Medium	Sales= IDR 3,823,597,025 Number of employees = 27
02	PT. IDM	Small	Sales = IDR 1,660,616,589 Number of employees = 10
03	PT. ABP	Small	Sales = IDR 1,388,659,783 Number of employees = 11
04	PT. SI	Medium	Sales =IDR 500,888,000,000 Number of employees = 23
05	CV. BB	Small	Sales = IDR 1,979,574,687 Number of employees = 12
06	PT. BI	Medium	Sales = IDR 3,722,442,979 Number of employees = 20
07	PT. Jty	Medium	Sales =IDR 4,584,676,000 Number of employees = 35
08	CV. FS	Small	Sales = IDR 698,580,270 Number of employees = 5

09	PT. TA	Medium	Sales =IDR 3,028,054,150 Number of employees = 27
10	PT. SanIn	Medium	Sales = IDR23,720,436,295 Number of employees = 44

(Sources : Meliala T., Elizabeth T.M., Francisca, Free Cash Flow Report for LPPM UNPAR, 2012)

From the Financial Statement (Income Statement and Balance Sheet) reported by the company, here are some examples of statement of cash flow and free cash flow calculation for three companies :

(1) "APT" M"
CASH FLOW

FOR THE YEAR ENDED December 31, 2010

Cash from operating activities:			
Cash received from customer	3,823,597,025		
	102,706,270		
	<u>36,323,278</u>	3,962,626,573	
Interest dividend received	----		
Cash payment for purchase	3,356,470,784		
	4,824,484		
	<u>(251,704,221)</u>		
Cash payment for expense	246,416,476	3,109,591,047	
	(25,487,500)		
	<u>(857,393)</u>		
Interest & tax payment	30,980,950	220,071,583	
Net increase in cash from operating activities:		30,980,950	601,982,993
Investing Activities:			
Purchases of plant assets	-		
Proceeds from sales of assets	-		
Net increase in cash from investing activities:			
Financing Activities:			
Proceed from short term borrow	-		
Payment debt	-		
Dividend paid			
Net Increase in cash from Financing Activities:			
Net Increase in Cash:			6,438,711

• Cash beginning = 257,328,702

Increasing = 6,438,711
Cash ending = 263,767,413

Cash in Balance Sheet = 263,767,413

(2) "CV BB"
Cash Flow

For The Year Ended 31 December 2010

Cash from operating activities:			
Cash received from customer	1,963,087,255		
	922,000		
	<u>1,400,231,021</u>	3,364,240,276	
Interest dividend received	1,508,313,810		
Cash payment for purchase	35,860,500		
	<u>(831,973)</u>		
Cash payment for expense	1,635,044,868	1,543,342,337	

	(2,039,548)		
	7,031,950		
	<u>(26,970,250)</u>	1,613,067,020	
	(19,289,548)	(19,289,548)	
Interest & tax payment (previous depreciation)			
Net increase in cash from operating activities:			188,541,371
Investing Activities:			
Purchases of plant assets	-		
Proceeds from sales of assets	-		
Net increase in cash from investing activities:			
Financing Activities:			
Proceeds from short term borrow	-		
Payment debt	78,079,292		
Dividend paid			
Net Increase in cash from Financing Activities:			78,079,292
Net Increasing in Cash:			110,462,079

• Cash beginning = 279,505,752
Increasing = 110,462,079
Cash ending = 389,967,831
Cash in Balance Sheet = 389,967,831

(3) "PT ABP"

Cash Flow

For The year ended 31 December 2010

Cash from operating activities:			
Cash received from customer	1,388,659,783		
Interest dividend received	<u>27,504,155</u>	1,415,163,938	
Cash payment for purchase	119,930,399		
	<u>180,022,670</u>	299,952,969	
Cash payment for expense	1,303,238,038		
	(66,191,328)		
	<u>(166,666,668)</u>		
Interest & tax payment		1,070,380,042	
Previous Loss			
Net increase in cash from operating activities:		<u>(78,105,409)</u>	122,936,336
Investing Activities:			
Purchases of plant assets	-		
Proceeds from sales of assets	-		
Net increase in cash from investing activities:			
Financing Activities:			
Proceeds from short term borrow	-		
Payment debt	-		
Dividend paid	-		
Net Increase in cash from Financing Activities:			
Net Increasing in Cash:			122,936,336

• Cash beginning = 22,366,278

Increasing = 122,936,336
Cash ending = 144,302,614

Cash in Balance Sheet = 144,302,614

Based on Weygandt K. J. theory of free cash flow (2007) the formula explained as follow :

$$\text{Free cash Flow} = \text{Net Cash Flow from operating activities} - \text{Capital Expenditure current year} - \text{Dividend paid to shareholders.}$$
 This formula used to calculate and report the free cash flow each company below

Company Name	Cash from Operating Activities	Capital Expenditure & Dividend (-/-)	Free Cash Flow
APT. M	IDR 601,982,993	Devidend = IDR 595,544,282	IDR 6,438,711
PT. IDM	IDR 188,541,371	Devidend = IDR 78,079,292	IDR 109,462,079
PT. ABP	IDR 122,936,336	---	IDR 122,936,336
PT. SI	IDR (4,423,952)	---	IDR (4,423,952)
CV. BB	IDR (45,353,813)	Devidend = IDR 1,001,098	IDR (46,353,911)
PT. BI	IDR (49,451,121)	Devidend = IDR 891,000	IDR (50,342,121)
PT. Jty	IDR 154,245,000,000	Capital Expenditure = IDR 117,182,000,000 Devidend = IDR 62,167,000,000	IDR (25,104,000,000)
CV. FS	IDR (27,526,980)	---	IDR (27,526,980)
PT. TA	IDR 101,292,062	Devidend = IDR 8,758,099	IDR 92,533,963
PT. SanIn	IDR 116,662,443	Capital Expenditure = IDR 27,500,000	IDR 89,162,000,000

Comparative Cash Balance (Actual VS Estimating FCF) :

Company Name	Cash Balance (Dec 31) – ACTUAL	Free Cash Flow	Estimating Cash Balance (from FCF)
APT. M	IDR. 263,767,413	IDR 6,438,711	IDR. 257,328,702
PT. IDM	IDR. 389,967,831	IDR 109,462,079	IDR. 280,505,752
PT. ABP	IDR. 147,302,514	IDR 122,936,336	IDR. 24,366,178
PT. SI	IDR. 7,013,922	IDR (4,423,952)	Deficit in cash, no financial data from previous year

CV. BB	IDR. 16,490,050	IDR (46,353,911)	Deficit in cash
PT. BI	IDR. 177,801,279	IDR (50,342,121)	Deficit in cash
PT. Jty	IDR. 10,048,000,000	IDR (25,104,000,000)	Deficit in cash
CV. FS	IDR. 2,712,463	IDR (27,526,980)	Deficit in cash
PT. TA	IDR. 186,096,125	IDR 92,533,963	IDR. 93,562.162
PT. SanIn	IDR. 296,240,866	IDR 89,162,000,000	Cash ending balance is not sufficient

V. CONCLUSION

There are several important findings from calculation above as follow :

- ❖ Net Increasing in Cash from Cash Flow Calculation in 2010

Company Name	Net Increase/Decrease in Cash	Company Name	Net Increase/Decrease in Cash
APT. M	IDR. 6,438,711	PT. IDM	Rp. 44.451.121
CV. BB	IDR. 110,462,079	PT. SI	Rp. (25.104.000.000)
PT. ABP	IDR. 122,936,336	CV. FS	Rp. (7.695.730)
PT. BI	IDR. (3,379,447)	PT. TA	Rp. 92.533.962
PT. Jty	IDR. (3,715,699)	PT. SanIn	Rp. (137.102.582)

- ❖ Net Free Cash Flow:

Company's Name	Free Cash Flow	Company Name	Free Cash Flow
APT. M	Rp. 6.438.711	PT. IDM	Rp. (50.342.121)
CV. BB	Rp. 109.462.079	PT. SI	Rp. (25.104.000.000)
PT. ABP	Rp. 122.936.336	CV. FS	Rp. (27.526.980)
PT. BI	Rp. (4.423.952)	PT. TA	Rp. 92.533.963
PT. Jty	Rp. (46.353.911)	PT. SanIn	Rp. 89.162.000.000

- ❖ There are four companies with over cash balance amount (between 6-123 million rupiahs), and the other four company are deficit in cash (between 29-15,056 million rupiahs). Two last companies have a deficit in cash but they can still use the cash balance from previous year to cover it.

Suggestions

All companies are advised to prepare a Statement of Cash Flow in order to calculate the amount of Free Cash Flow, which in turn will determine the correct balance for cash that the company should have. It is important to avoid overstated or understated cash balances which may result in company's losses as well as to improve the cash management in the company.

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