

**AN EVALUATION OF THE USEFULNESS OF THE CASH FLOW STATEMENT
WITHIN SOUTH AFRICAN COMPANIES BY MEANS OF CASH FLOW
RATIOS**

by

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**Submitted in Fulfillment of the Requirements for the Degree of Doctor of
Commerce in the Faculty of Economic and Management Sciences**

UNIVERSITY OF PRETORIA

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SEPTEMBER 2004

ACKNOWLEDGEMENTS

I wish to extend my sincere thanks and gratitude to everyone who contributed in some way towards the completion of this study. Personal contributions by the following people are acknowledged:

My Saviour without whom I would not have been able to complete this study.

Professor J. de la Rey, my promoter, who has guided me with his insight and advice.

The Port Elizabeth Technikon and NRF for their financial support.

Ina Botes from the BFA and Chrissie Boeyens from the University of Pretoria for their useful and valuable guidance.

My colleagues for their interest and support and, in particular, Marcelle Harran and Sandy Blunt for editing the dissertation.

My friends and family for their interest and encouragement.

Last, but not least my husband, Paul, and sons, Paul (jr) and Lion for their love and inspiration especially during the last months of this study.

‘Solvency is a money or cash phenomenon. A solvent company is one with adequate cash to pay its debts; an insolvent company is one with inadequate cash. Evaluating solvency is basically a problem of evaluating the risk that a company will not be able to raise enough cash before its debts must be paid. Solvency analysis is not simply a matter of evaluating a company’s so-called current assets and liabilities...’

Heath and Rosenfield 1979 (Sharma, 2001:17).

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SUMMARY

With the introduction of SFAS 95 in 1987, the cash flow statement became an integral part of financial reporting. With this a need arose for the development of ratios for the effective evaluation of the cash flow statement.

The primary objective of this study was to determine the usefulness of the cash flow statement by means of cash flow ratios. Beaver (1966) was the first researcher to stress the importance of cash flow information for predicting financial failure and, therefore, the study investigated the available cash flow ratios of various authors.

Eight cash flow ratios were suggested for inclusion in a financial analysis. Failed entities were selected and evaluated by means the selected cash flow ratios for five years prior to their failure. Non-failed entities were selected and included in the evaluation. The results of the ratios were used to calculate mean values for each ratio and year prior to failure. The ratios of the failed entities were compared with those of the non-failed entities.

A comparison of the ratios revealed that the cash flow ratios have predictive value. The cash flow to total debt and ratio was identified as the ratio with the greatest potential to predict financial failure. The mean value of the ratio was weaker than the mean of the non-failed entities in four out of five years. The mean values of the cash flow ratios of the failed entities performed weaker overall than the non-failed entities.

Failed entities not only have lower cash flows than non-failed entities but they also have smaller reserves of liquid assets. Therefore, they have less capacity to meet obligations and they tend to incur more debt. The ratios of the failed entities were also unstable.

The study concluded that cash flow ratios calculated from the cash flow statement enhanced the usefulness of financial statements. A need, however, remains for consensus on a comprehensive set of cash flow ratios for financial analysis. If cash flow ratios are used in conjunction with traditional ratios it should lead to a better understanding of the financial strengths and weaknesses of an entity.

LIST OF ABBREVIATIONS

AC	Accounting Standard
AICPA	American Institute of Certified Public Accountants
APB	Accounting Practices Board
APC	Accounting Practices Committee
ASB	Accounting Standards Board
BFA	Bureau of Financial Analysis
CICA	Canadian Institute of Chartered Accountants
DP	Discussion Paper
ED	Exposure Draft
FASB	Financial Accounting Standards Board
FRS	Financial Reporting Standard
GAAP	General Accepted Accounting Practice
IAS	International Accounting Standard
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
JSE	Johannesburg Securities Exchange
NCCA	National Council of Chartered Accountants
SAICA	South African Institute of Chartered Accountants
SCFP	Statement of changes in financial position
SFAC	Statement of Financial Accounting Concepts
SFAS	Statement of Financial Accounting Standard
UK	United Kingdom
USA	United States of America

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