

## CASH FLOW STATEMENT IS A USEFUL TOOL FOR MEASURING CREDIT WORTHINESS OF THE MSMEs - A CASE STUDY

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### ABSTRACT

*This paper is an attempt to justify how a projected cash flow statement be a useful tool for judging credit worthiness of MSMEs to measuring the credit risk involve in MSME finance. 100 MSMEs registered under DICC of Jorhat and Sivasagar districts of Assam have been randomly selected consisting 40 each from Micro and Small and 20 from Medium entrepreneurs based on their investment in plant and machinery as defined under MSME Act, 2006. 50 public sector bank branches have also been selected randomly from both the selected districts covering all the 17 community blocks. The study revealed that majority portion of respondent MSMEs (i.e. 80 percent) are dependent on professionals in filing their loan proposals and thereby misunderstands between the borrowers and lenders in presenting loan proposals. A majority portion of bank managers ( i.e. 90 percent) are in favour of replacing income statement and position statement by cash flow statement , as cash flow statement reflect generation and utilization of cash of MSME units and this can be verified with the income tax return filled by the borrowers.*

**Key Words:** MSMEs, Cash Flow Statement, Accounting ratio, Bank Credit, Financial Statements, Credit wordiness

### INTRODUCTION

The Micro, Small and Medium sector has been consistently registered higher growth compared to the overall industrial growth in respect to GDP and employment generation in particular. As per the Fourth All India census of MSMEs, the sector employees around 60 million people across 30 million enterprises and in terms of value, the sector account for about 45 percent of India's manufacturing outputs and over 43 percent of the total export. Despite these effort banks credit to MSME sector witnessed a CAGR of 31.4 percent during the period of March 2006 to March 2012. Banks have been apathetic towards lending to MSMEs, apprehended that loans given to MSMEs may became non-performing assets.

The Micro, Small and Medium Enterprises (MSMEs) with its present strength of 2.5 crore units employs 60 million odd people is struggling to stay afloat as many as 4, 80,946 units closed down over the five years period preceding 2006 and another 77,723 units were declared sick as reported by "The Fourth All India Census of MSMEs", 2006-07, released on November 19, 2010. The report also highlights that obtaining adequate and timely credit especially working capital loan is the major problems for promotion of MSME sector.

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Government is also taking steps to enhance the development of MSMEs, by introduction of various schemes involving credit rationing, training for technology and development of skills etc. This was first initiated in the Twelfth Five Year Plan (2012-17), where an expenditure of Rs 24,124 crore has been provided for Ministry of MSME. In comparison to Eleventh Five Year Plan, it was estimated to be an increase of 133.53%. There are 2887 specialized SME branches of public sector banks operational as on 31<sup>st</sup> March, 2014, including those existing SME clusters. In addition, Small Industries Development Bank of India (SIDBI) has set up Credit Advisory Centers (CACs) in partnership with cluster level industry association. So far 50 CACs conversing 306 clusters all over India, as reported by the Union MSME Minister Kalraj Mishra in the Lok Sabha on 13<sup>th</sup> August, 2014.

Banks have traditionally relied on a combination of documentary evidences for some information, interview with the applicants, experience after visiting field and the personal knowledge and expertise of managers/officials in assessing and maintaining business loans for sanctioning loan. However, in case of small business loan banks largely rely on standardized credit scoring techniques especially cash flow of business or owners.

A Cash Flow statement is a statement which is prepared by acquiring cash from different sources and the application of the same for the different payment throughout the year (Paul and Paul, 2013). The objective of cash flow statement is to present the historical changes of cash and cash equivalent of a firm by means of a cash flow statement which classifies cash flows during the period according to operating, investing and financing activities to be presented as per IND AS-3.

### **REVIEW OF LITERATURE**

**Global perspective:** An Australian study conducted November, 2006 on accounting practice among SMEs revealed that the accounting services SMEs must concern a serious discussion need to be developed. Greenhalgh Robert included a survey based on empirical research on management accounting in SMEs which examine the influence of contextual variables.

The most ambitious attempt ever to harmonious accounting practice in SMEs was developed in International reporting standard for SME, IASB published draft SME on 3rd April, 2007. Statement of generally accepted accounting practice for SME an article published on 10<sup>th</sup> October, 2007 and by accounting practice board (APB) on 7<sup>th</sup> August, 2007 shows the importance of GAAP in SMEs.

Zaman and Gadenne (2002) developed a model for enhancing the performance of (SMEs), which was known to be 'best financial and cost accounting practice'. It aimed to bring effectiveness in the practices of strategic planning, budgeting and budgetary control. This helped in understanding the link between strategic planning in financial and cost accounting and financial effectiveness.

Moscove (1977) concluded that, accounting is mainly concern with converting the quantitative data into useful information through the process of interpretation and communication. The author stated that, before granting a loan to any organization the

bank want to be reasonably sure that the recipient will be able to pay it back plus interest, at the due date. The final decision on the loan application will be based on the information supplied by the financial accounting system.

Nickerson (1906) stated accounting is a language both figuratively and literally. It is a set of recognized symbols, arranged according to established roles and principles in such a way that they convey meaning. It has its own vocabulary and syntax like any language it has certain ambiguities. An understanding of accounting is essential for a good businessman. The author stress on income statement and fund flow statement rather than balance sheet and emphasizes on importance of transaction of critical accounting areas such as depreciation, inventory valuation, cost accounting and budgeting.

Bharadwaj (1996) explained his views by answering a few questions which demand reasonable answers, what skills should be adopted in processing and recording business figures? In what manner should the resultant information be presented to those for whom it is intended? Is that information in line with legal requirements? He also stated that, a very important function of modern accounting is reporting to the users and report should possess qualities such as relevance, understandability, verifiability timeliness completeness etc.

Ray (1994) expressed the importance of accounting by explaining the words such as debit, credit, ledger, day books, control account accruals provisions etc. and hence became an integral part of the accountant's language in order to maintained the separation between those in the known from those outside. The use of computers for accounting systems was perhaps one of the first steps in bringing the accountant's operation back within the reach of other part of the business so far accounting information is concern.

Egginton (1977) exclaimed that the banker's interest in accounting information in particularly concerned with lending. As a lender he has more opportunity to explore behind the customer's annual financial reports than the "arms length' user for whom those report are primarily prepared. The bank manager always insist on regular cash flow statement for granting overdraft to a firm and recognized as useful document for providing finance. The banker seeks details accounting information beyond the annual accounts tends to depend on the circumstances of the lending.

## **INDIAN PERSPECTIVES**

In India, since the beginning of accounting education in Sydenham College at Bombay, accounting education has been occupying an important part of the university curriculum at both undergraduate and post graduate level. The Accounting Standard Board (ASB) of the Institute of Chartered Accountant of India (ICAI) expressed their views that an SME be required to choose either of accounting standards applicable for them.

The MSMED Act, 2006 rightly says that, Indian SMEs must adopt either of two basic accounting system ( i.e. Single Entry System or Double Entry System) but some relaxation and exemption have been provided to SMEs in respect International standards and practice for accounting, Audit and non-financial disclosure of SMEs.

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Lal (2009) opined that company financial reporting has been debated and discussed with a view to provide satisfactory solutions to many aspects of company reporting for the benefits of different user groups. He also expressed his view that, there is a need for bridging the gap between theory and practice to enhance relevance and meaningfulness of financial disclosure and to improve financial reporting practices.

The Auditing and Assurance Standards Board of the Institute of Chartered Accountant of India (ICAI), (2008) has taken a significant step as it has brought out “A Practitioner’s Guide to Audit of Small Entities” . The Guide is an attempt to suggest a simplified application of the principles enunciated in the Auditing and Assurance Standards for small entities. It is felt that, application of auditing in case of small entities has been posing difficulties for the practitioners on account of factors such as peculiarities of the internal control systems in these type of clients, nature of transactions, nature of record keeping and time and cost involved in application of these standards. It is perhaps for the first time, the Institute is bringing out this kind of guide for the small entities.

Desai (2009) explained about the financial reporting. It deals with the presentation of data in a form for which it can be utilized comparative appraisal of the projects. It is concerned with the development of the financial profile of the project to find out whether the project is attractive enough to secure funds needed for its various constituent activities and once having secured the funds, whether the project will be able to generate enough economic values to achieve the objectives for which it is sought to be implemented. The author stated that, since the financial reporting is influence by certain factors such as large scale production, regulatory provision, income-tax accounting, executives, bankers, investors, mercantile credit etc., therefore it should be properly presented for the parties for whom it is prepared.

Khanka (2005) explained the main objectives of the accounting, to provide accounting information to the interested parties such as bankers, creditors, tax authorities, prospective investors, researchers etc. Hence accounting information should provide to these users to enable them to take sound and realistic decisions and it should be made available to them in the form of annual report.

Raju (2008) shows that, Income statement and balance sheet may be replaced by Cash flow statement while judging the financial soundness of the MSMEs .

The above reviewed literature indicates there is no in depth study has been carried out in the thrust area. The present study is an attempt to resolve the issue to promote the MSME sector by providing timely and adequate credit to the sector.

### **OBJECTIVES OF THE STUDY**

The paper addressed the following objectives:

1. To identify whether poor presentation of financial statements is a major problem in credit wordiness of the MSME sector.

2. To see whether the projected cash flow statement is the best tool for judging the creditworthiness of the MSMEs in providing credit.
3. To test framed hypothesis whether a projected cash flow statement is an useful measuring tool for judging creditworthiness of MSMEs.

## METHODOLOGY

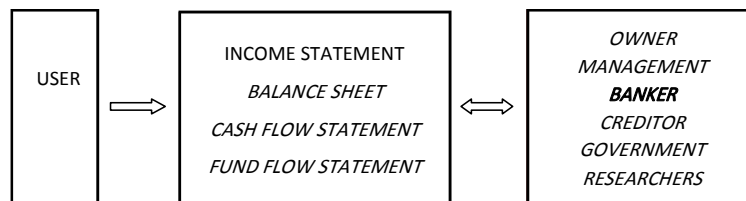
The present case study is analytical in nature and based on both primary and secondary data. 100 MSMEs registered under DICC of Jorhat and Sivasagar districts of Assam have been randomly selected consisting 40, each from Micro and Small and 20 from Medium entrepreneurs based on their investment in plant and machinery as defined under MSME Act, 2006. Selected MSMEs are categorized as profitable units but received inadequate finance. Stratified random sampling has been adopted to select the MSMEs. 50 public sector bank branches have also been selected randomly from both the selected districts covering all the 17 community blocks. A projected Cash Flow Statement is prepared based on the financial statements prepared by MSME respondents and same has been presented to the selected banks in the study area to draw the conclusion with the help of framed hypothesis. The collected data first inserted in the MS excel and then the same data has been placed in the Predictive Analysis Software Package to test the hypothesis.

## HYPOTHESIS

The Null hypothesis has been framed for the study as, “There is no significant difference in the opinions of the Bank managers and Credit officers that, data contains in the cash flow statement is more authentic and hence a useful tool for measuring credit worthiness of MSMEs”.

## SIGNIFICANCE OF THE STUDY

Figure-1: Financial Statements User chain



MSMEs whenever approaches to banks and financial Institutions for financial assistance the banker at the first instance raised the questions, how's your unit financial health? Where does its revenue come from, and where does it spend its money? How much profit is it making? Where is its cash coming from, and where is it going to? The business unit provides answers to such questions through three documents, called financial statements: the Income Statement, the Balance Sheet and the Cash Flow Statement.

An income statement tells whether a business unit is making a profit, and a balance sheet can tell about the position of assets and liabilities for a specific period of time. It is the

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cash flow statement that tells whether a business unit is turning its profits into cash. A cash flow statement provides various information to the banker relating to financial health of a firm in the following way:

- To assess the ability of a firm to pay its obligations as soon as it becomes due.
- To analyze and interpret the various transactions for future courses of action.
- To see the cash generation ability of a firm.
- To ascertain the cash and cash equivalent at the end of the period.
- To prepare the firm's cash planning for the future to avoid any unnecessary overdue.
- To exhibit the changes of financial positions relating to operation activities, investing activities and financing activities by which a banker can draw his conclusion on ability of firm to repay its loan.
- An income statement tells us about the profit earns by the firm but a cash flow statement tells us how the profit turn into cash.
- A balance sheet shows the position of assets and liabilities of a firm, but a cash flow statement shows whether cash generate or use from these assets and liabilities through investing and financing activities.

Accounting ratios such as Cash turnover ratio, Cash return on assets, Cash flow margin, Cash adequacy ratio, NPV, IRR, Break-even point calculates based on cash flow statement are the best tool for judging the financial health of the MSMEs.

A stable accounting database ensures standardization, uniformity, inter firm comparison and internal rating of the proposal form that need to fill by MSMEs while approaching banks for lending. The present study signifies how a projected cash flow statement is useful for measuring financial health of the MSMEs while lending them by banks. In this context the paper highlighted the need of presenting cash flow statement by MSMEs while approaching banks for financial assistance.

### ANALYSIS AND FINDINGS OF THE STUDY

The data have been collected on five points rating scale by assigning 5,4,3,2 ,and 1 respectively for totally agree, partially agree, No opinion, Partially disagree and Totally disagree. The mean scores and Chi square values have been calculated accordingly. The chi square test has been used for operationalisation of hypothesis. The first part of the analysis of the study deals with the perceptions of bankers on acceptance of financial statements for judging the credit worthiness of the MSMEs.

**Table 1: Responses of the bankers (50)**

Financial Statements	Respondents in favour	Percentage	Respondents not in favour	Percentage (%)
Income Statement	8	16	42	84
Balance Sheet	9	18	41	82
Cash flow statement	45	90	5	10

Source: Compiled data

It is seen from the above table that, 90 percent of the respondents' bankers are in favour of accepting the Cash flow statement while judging the credit worthiness of the MSMEs. The respondents justifies that, data contains in the cash flow statement is more authentic and a cross verification can be done between cash flow statement and Income tax return. The second part of analysis has been done by calculating the different accounting ratios from the data contained in the consolidated cash flow statement and presented to the bankers for the opinion pool adopting PASW- 18 package.

**Table 2: Opinion about acceptance of Financial Statements for judging credit worthiness with the help of accounting ratios**

Financial Statements	Accounting ratios used as determiners	Chi-square value	Df	Asymp. Signi	H <sub>0</sub>
<b>Income Statement &amp; Balance Sheet</b>	Cash Turnover Ratio	21.11	1	0	Rejected
	Cash Return on Assets	13.17	1	0	Rejected
	Cash Flow Margin	2.77	1	0.09	Accepted
	Cash Flow Adequacy Ratio	12.781	1	0	Rejected
	Cash Position to Total Assets ratio	16.213	1	0	Rejected
	Net Present Value ( NPV)	12.347	1	0	Rejected
	Internal Rate of Return (IRR)	2.658	1	0.9	Accepted
	Breakeven Analysis	15.89	1	0	Rejected
<b>Cash Flow Statement</b>	Cash Turnover Ratio	2.679	1	0.102	Accepted
	Cash Return on Assets	2.437	1	0.103	Accepted
	Cash Flow Margin	2.145	1	0.9	Accepted
	Cash Flow Adequacy Ratio	2,098	1	0.105	Accepted
	Cash Position to Total Assets ratio	2.897	1	0.122	Accepted
	Net Present Value (NPV)	2.88	1	0.102	Accepted
	Internal Rate of Return (IRR)	2.675	1	0.112	Accepted
	Breakeven Analysis	2.876	1	0.109	Accepted

**Source:** Compiled from PASW-18

There is no significant difference in the opinions of the respondents (bankers) with respect to judging credit worthiness of the MSMEs with the help of accounting ratios based on cash flow statement is the perfect tool. It is found that, there is a significance difference in the opinions of the respondents on judging creditworthiness of the MSMEs with the help of accounting ratios based on Income statement and Balance sheet. The respondents stated that, data contains in the Income statement and Balance sheet is not authentic as these statements are prepared by the professional accountants as per demand of the loan proposals to satisfy the lenders.

The third part of the analysis deals with the accounting ratio based on data contains in the cash flow statement in judging financial health of the MSMEs whether effective.

**Table 3: Perceptions about effectiveness of accounting ratios through cash flow statement**

Accounting Ratio	Chi- Square Value	Df	Asymp. Signi	H <sub>0</sub>	Mean Score	Interpretation
Cash Turnover Ratio	4.8	2	0.091	Accepted	1.64	Effective
Cash Return on Assets	5.889	2	0.053	Accepted	1.76	Effective
Cash Flow Margin	1.724	2	0.422	Accepted	1.79	Effective
Cash Flow Adequacy Ratio	11.726	2	0.033	Rejected	1.76	Effective
Cash Position to Total Assets	1.3	2	0.522	Accepted	1.9	Effective
Net Present Value (NPV)	1.863	2	0.394	Accepted	1.68	Effective
Internal Rate of Return (IRR)	0.315	2	0.854	Accepted	1.83	Effective
Breakeven Analysis	1.423	2	0.412	Accepted	1.78	Effective

**Source:** Compiled from PASW-18

There is no significance difference in the opinions of the respondents about the effectiveness of accounting ratio calculated from the cash flow statement while judging the credit worthiness of the MSMEs. All the respondents are in opinion that, calculated accounting ratios from cash flow statement are more authentic for judging credit worthiness of the MSMEs.

**The major findings of the study are:**

1. The result of hypothesis shows that, there is no significance difference in the opinions of the respondents (Bankers) with respect to cash flow statement is the best tool for judging the credit worthiness of the MSME units. As 85 percent of the selected respondent felt that the cash flow statement is most effective in calculating the Internal Rate of Return (IRR) on the basis of Net Present Value (NPV) which can be compared with the hurdle rate or base rate at the time of selecting MSMEs for finance.
2. 90 percent respondents stated that, since according to IFRS the banks are to follow fair value technique while valuing assets and liabilities of the banks, it is the cash flow statement which can give best support in this context.
3. 75 percent respondents stated that, data contains in the income and position statements are manipulated as it is prepared by the professional accountant as per the demand of the loan proposals to satisfy the lender and hence it is not an authentic document.
4. 87 percent respondents expressed their views that a cross verification can be made for the data contains in the cash flow statement with the Income tax return filled by the MSME borrowers which can be judged the financial health of the MSMEs.
5. 75 percent respondents stated that, calculating IRR on the basis of NPV from projected cash flow statements gives more accurate result than calculating it from income and position statement.



## CONCLUSION

The banking companies are to present their financial statements under International Financial Reporting Standard (IFRS) w.e.f. 1<sup>st</sup> April, 2013 where fair value method to be adopted by the banks under this situation NPV and IRR should be made compulsory while judging the MSMEs. Credit worthiness of the MSMEs should be addressed in the right way in order to promote the sector by providing adequate and timely credit as bankers do not consider the MSMEs as their valuable customer because of volatile profitability. In this context the regulatory bodies like SEBI, RBI, ICAI, and academicians should formulate a measuring tool to judge the financial health of the MSMEs. The cash flow statement may be taken into consideration to resolve the issue. The study revealed 90 percent respondents are in favour of opinions that, cash flow statement is the best tool for judging credit worthiness on their ability to repay the loan amount. The study suggests adopting a revised format of cash flow statement and direct method for calculating cash flow from operating activities for MSME units would be more appropriate.

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