FREE CASH FLOW AS PART OF VOLUNTARY REPORTING. LITERATURE REVIEW

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The present study has as main objective to reflect the state of literature regarding free cash flow, and to withdraw the main pro's and con's in order to create an objective image upon this indicator. The main idea generating this research was the growing interest on cash flow reporting. As many say, "Cash Flow is King", while in Anglo Saxon countries the interest of investors and analysts in concentrated on operating cash flow, as the most important indicator of the probability of bankruptcy. In this context, voluntary additional reporting, like free cash flow may come either as an aid in providing the fair view or as an opportunistically reported figure. Throughout the paper, the intention was to provide answers to three main research questions: "What are the definition and calculation method of free cash flow? Why is there an interest in free cash flow reporting? What is the impact of free cash flow on the agency theory?" In order to provide relevant conclusions, four international data basis were used, and related articles and studies were extracted. *The results proved that there is no generally accepted definition and computing method, while the format depends on the end-user of the report (shareholders, investors, analysts, bankers, a.s.o.). As stated below, this aspect generates confusion and lack of comparability, giving room to creative accounting techniques. Moreover, the interest on free cash flow reporting is connected mainly to liquidity assessment, company valuation and investors' choice. Still, in the context of agency theory, results show that in presence of high free cash flow, managers tend to make investment choices that satisfy their personal interest and that generate low efficiency and profitability for the company. The contribution to current state of research is providing a literature review study, focused on a comparative approach, as well as on underlying an objective image upon a debatable financial indicator and accounting report.*
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1.Introduction

In a fast moving and transforming reality, information is the essential instrument for a manager, investor, or regulations setters. The financial strategy of any company cannot be set without taking into account the cash flow evolution. Alongside the balance sheet and profit and loss account, cash flow statement is one of the instruments for assessing the performance of a company. It gives valuable information upon the liquidity of the company, illustrates very well the difference between profitability and liquidity. Based on it, the managers can take action in due time, to control possible future problems that could lead to bankruptcy, or decide to continue cash-rich activities.

The current format of the cash flow statement is the result of a rather recent process. The national differences are reduced by the growing influence of the International Accounting Standards Board. Still, the first draft of the "funds statement" was published in 1976, by the International Accounting Standards Committee), which was followed by the revised cash flow statement (IAS 7), coming into force in 1994. Since then, it has been the cause of ongoing debates upon the best presentation method and the effect of the allocation choices of the components. The interest upon this statement rose mostly in Anglo-Saxon countries, where the capital market is the main external financing source the investors being mostly interested in the benefit of dividends, but also where main financial scandals outlined the implications of creative cash flow.

Apart from the mandatory reporting, especially in the Anglo-Saxon countries, managers also voluntarily report other information related to the cash flow, like the so called "free cash flow", a most debated notion. **The present study has as main objective to reflect the state of literature regarding free cash flow, and to withdraw the main pro's and con's in order to create an objective image upon this indicator.** In order to achieve the main objective, the secondary goals are to answer to the research questions stated below.

2.Research Methodology

In order to create a data base of relevant studies, four international sources were chosen: Ebsco, Science Direct, Wiley and Emerald. The research process started by selecting all the articles containing the words "cash flow", in their title, keywords or abstract, issued after 2000. The result was of 1,168 articles from Ebsco database, 976 from Science Direct, 536 from Wiley and 141 from Emerald database. After assessing their relevance and connection to the accounting field, as well as the availability of the full text (Cluj-Napoca, Central University Library access), the final sample consisted out of 239 articles (162 from Ebsco, 36 from Science Direct, 10 from Wiley and 31 from Emerald). The main ideas and hypotheses related to free cash flow were identified, through analysis, synthesis and generalization processes. The main opinions presented, based on which the concluding remarks were constructed, were from studies concentrating on the indicator of free cash flow while being representative for the type of issues raised by accounting and financial specialists.

The main areas identified try to give response to the following **research questions**:

Why is there an interest in free cash flow reporting? What are the definition and calculation method of free cash flow? What is the impact of free cash flow on the agency theory?

3.Developing the research process

What are the definition and the calculation method of free cash flow?

There is a diversity of opinions in defining this notion. Adhikari and Duru (2006: 311-322), consider cash flow to be the amount of cash available to shareholders, without reducing the business value. They calculate this indicator by deducing from the operating cash flow the amounts needed for capital expenditures, in order to maintain the production capacity of the company. They acknowledge also the possible definition relating to free cash flow as the cash remaining at the managers' free choice, obtaining the final value by deducing from operating cash flow the amounts needed for capital expenditure, dividend payment and loans reimbursement.

Roger Hussey & Andra Ong (2005: 268) define cash flow as a measure of the amount of cash available for dividend payment, financial debts payment and for development of the company. Artiachea, Leea, Nelson & Walker (2010: 31-51), consider free cash flow an assessment of the company's liquidity, while a high figure indicates a financial capacity of investing in sustainable projects, without sacrificing the claims of third parties. PhD. Prof. Ioan Batrancea (2008, 135-136), describes free cash flow as "money put aside", being in fact cash generated by the company for its shareholders, after paying financial debts and performing necessary development investments.

Kousenidis (2006, 645:653) considers free cash flow to be the operating profit after tax payments, after non cash adjustments, and investments in current and long term assets. The appropriate definition is considered to be the cash generated by the company, available for all the parties insuring the capital of the company (equity and financial debt).The same calculation principle is adopted by Nick Antill & Kenneth Lee (2008, 19), except for the non-cash elements, replaced solely by depreciation.

Hackel, Livnat & Rai (2000: 1-24) asses free cash flow to be the operating cash flow, after deducting capital expenditures, acknowledging potential errors arising from not separating the investments needed for maintaining current growth rate, from excess investing, depriving the shareholders from deserved "reward". Robinson, van Greuning, Henry & Broihahn (2009, 250-251) have the same vision, considering free cash flow as the operating cash flow exceeding the capital expenditure amount, while accepting also the extended formula taking into account non-cash adjustments. S.H. Penman (2001) also sees cash flow as generated by operational activities, after deducing investment cash flow. He also states the fact that low free cash flow could indicate future significant increase (when used to finance investments). Jones & Sharma (2001, 18-39), define free cash flow as the cash collections from customers, minus payments towards suppliers and cash outflows related to investments, while finding in certain conditions a statistically significant connection between free cash flow and earnings management. Mulford & Comiskey (2005: 345-376) consider free cash flow the antidote to earnings management, and admit that the definition depends on the users: cash flow available for dividend payment, for loan reimbursement and interest payments.

To conclude, there can be said that there is no unanimous definition and way of calculation, which is where the danger of opportunistic management may arise, as almost all specialists admit.

Why is there an interest in free cash flow reporting?

There are opinions stating that companies choosing to report free cash flow, do this in order to improve the image of their performance in the eyes of the analysts and investors (Adhikari & Duru, 2006), by proving that most of the companies studied had low profitability and high leverage. Others (Fuller & Blau, 2010) state that companies would report free cash flow so as to signal future dividend payments, observing that mostly medium performing entities adopt this kind of reporting. Mulford & Comiskey (2005, 345-376), believe this increasing interest in reporting the indicator is a result of a growing attention from investors towards cash flow in general. The same opinion was stated by other specialists, like David Henry (2008), or Robinson, van Greuning, Henry & Broihahn (2009, 250-251) and J.E. Ketz (2003: 236-237).

Still, the creative accounting techniques must be considered, and so some researchers associate free cash flow reporting to manipulative intentions of managers. J. Edward Ketz (2003: 236-237) draws attention on the free cash flow multiple possibilities of reporting, leaving the possibility for managers to choose the one favoring the company's figures. He provides the example of deducing the amount of free cash flow from earnings adjusted, leaving it with significant influence from potential earnings management or relying on the freedom of choice permitted by IAS 7 and including components in operating cash flow to boost its amount. Jones & Sharma (2001: 18-39), prove that for companies not reporting their cash flow on quarterly basis, there is a statistically significant positive relation between free cash flow amount and earnings management.

What is the impact of free cash flow on the agency theory?

Most of the studies focused on this issue rely on Jensen's (1986, 323-329) research that proves that if free cash flow amount is significant, managers will follow their own interests and engage in high investments with low profitability. Brush, Bromiley & Hendrickx (2000: 455-472), state that through high free cash flow, managers achieve their personal interests, without implications of capital market or existing shareholders. After studying 3.320 financial reports, concluded that free cash flow only leads to increasing turnover and profitability in cases of companies with low free cash flow and without strong corporate governance, companies with no free cash flow and most importantly, companies with shareholders involved in management. Zhang (2009, 507-541) thinks that managers tend to invest in excess when free cash flow is available, where there is weak corporate governance and no monitoring system, which can be mitigated by increasing financial debt, which restricts access to cash flow. Wei & Zhang (2008: 118-132) sustain this idea by proving that excess investment of free cash flow is a result of cheap internal sources, not to expensive resources from capital markets. Consistent with Jensen theory, Freund, Prezas & Vasudevan (2003: 87-106), demonstrate lower future performance for companies with high cash flow. Also in accordance, Nwaeze, Yang & Yin (2006: 227-265) prove that free cash flow in large amounts facilitates for managers discretionary management of investments, financial debt and dividend payments.

4.Conclusions and further research

By summing up the ideas discovered in relevant literature, we can find answers related to the research questions. However, to the first research question, the answer is that there is neither a generally accepted definition, nor a common way of calculation. Throughout the diversity generated by the existing opinions and practices, still there is one way of calculation preferred by analysts. It starts from operating cash flow, from which investing cash flow is deducted, the result being adjusted by interest payments and dividends paid. This option is not affected by accruals, thus falls off the influence of earnings management, while the result is the residual cash flow, over the break-even level, required for maintaining/increasing current production capacity.

The reason behind voluntary reporting of free cash flow is the intention of providing **positive signals** to the investors and analysts regarding the performance of the company, the potential of paying dividends and sustaining further investment. Still, the issue of manipulative free cash flow reporting is too be consider, while results prove that it might hide other flaws, mostly in profitability.

Potential creative accounting techniques should be considered when analyzing free cash flow. The growing interest in cash flow reporting was generated mainly by notorious financial scandals and frauds resulting from earnings management, but also is specific to countries with capital market as main external source of financing. All these aspects put cash flow reporting on a high place in the eyes of investors or banks, and raised the interest in free cash flow reporting.

In the context of **agency theory** the research work proves that managers tend to put their own interest first, by engaging in projects that would generate personal benefits. Moreover, due to cheap internal financing sources, managers tend to overinvest, with low profitability or value added.

Another outcome of the current study is a synthesis of main positive and negative aspects related to voluntary free cash flow reporting, provided in the table below:

Positive outcome	**Negative outcome**
Applicability in: - Liquidity analysis; - Company valuation process; - Determining potential personal future gains for investors; - Stating most relevant covenants in loan contracts; - Countervailing earnings management; - Managers' incentives.	-Reasons for issuing the report may be to hide other financial problems; -Low comparability due to diversity in reporting not standardized yet; -Negative implications in the context of agency theory: stimulates managers to invest in low profitability projects, or in their own interest; - Potential manipulative choices, deriving from high diversity of defining and computing methods.

Table 1: Pro's and con's regarding voluntary free cash flow reporting. Source: authors 'projection

The further research perspectives are numerous. They derive mostly from the variety of reporting methods, leading to low comparability but also from the connection between positive free cash flow and earnings management. Finding a unanimously accepted format is a goal for many researches and presents interest to standard setters and should start from finding the most relevant format for end-users (investors, bankers or analysts)
The current study contributes to the research area by providing a synthesis of most relevant studies preoccupied by free cash flow reporting, putting aside the main issues surrounding this financial indicator, providing grounds for further study, deriving from each of the research questions stated.

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