International Financial Accounting

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Session 4

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Cash flow statement

Session 4: Cash flow statement

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Introduction to cash flow statement

Statement of cash flows (IAS 7)

Introduction to cash flow statement

Statement of Cash Flows – Key Points

The Statement of Cash Flows provides supplementary information to the income statement

The income statement is prepared on an accrual basis

- Captures the changes between two balance sheets
- Provides more detail on increase in retained earnings for the year from operations
- A measure of performance

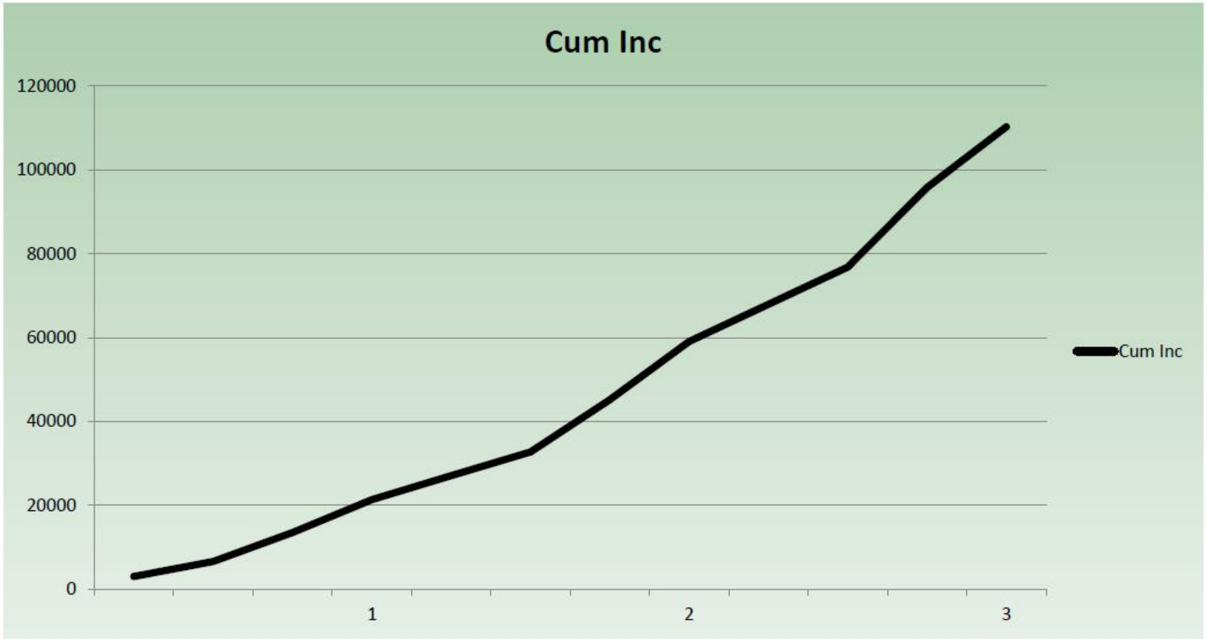
The statement of cash flow is prepared on a cash basis

- Captures the changes between a company's cash resources between two balance sheet dates
- A measure of performance

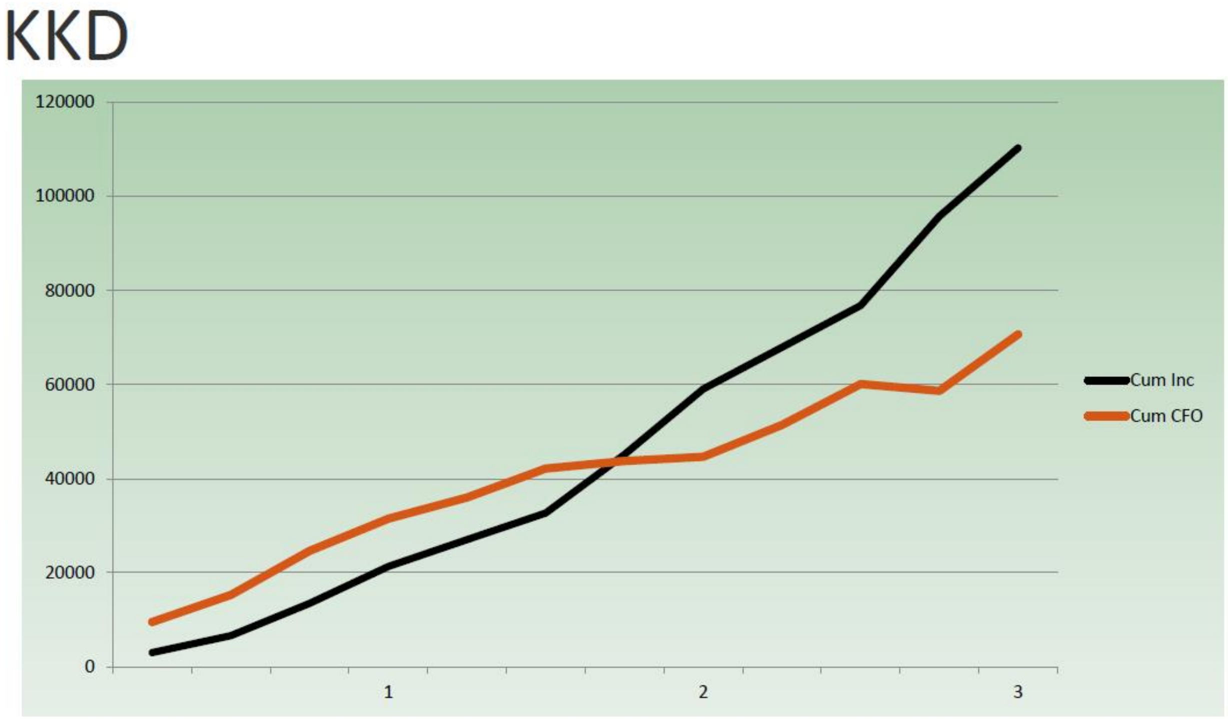
The income statement & cash flow statement provide complementary sources of information on an entity's performance (see examples in next slides)

Graph of cumulative income for KKD

KKD



Graph of cumulative income and cumulative cash from operations for KKD



Overview

The purpose of the statement of cash flows is to:

- Report cash receipts & cash payments over a period of time

- Classify the cash flows as operating, investing & financing activities
  - Collectively exhaustive = there are 3 & only 3 categories. Everything must be classified as O, F or I
  - Mutually exclusive = if it is O then it cannot be F or I

- Detail the <u>changes</u> in the cash account on balance sheet

Articulation

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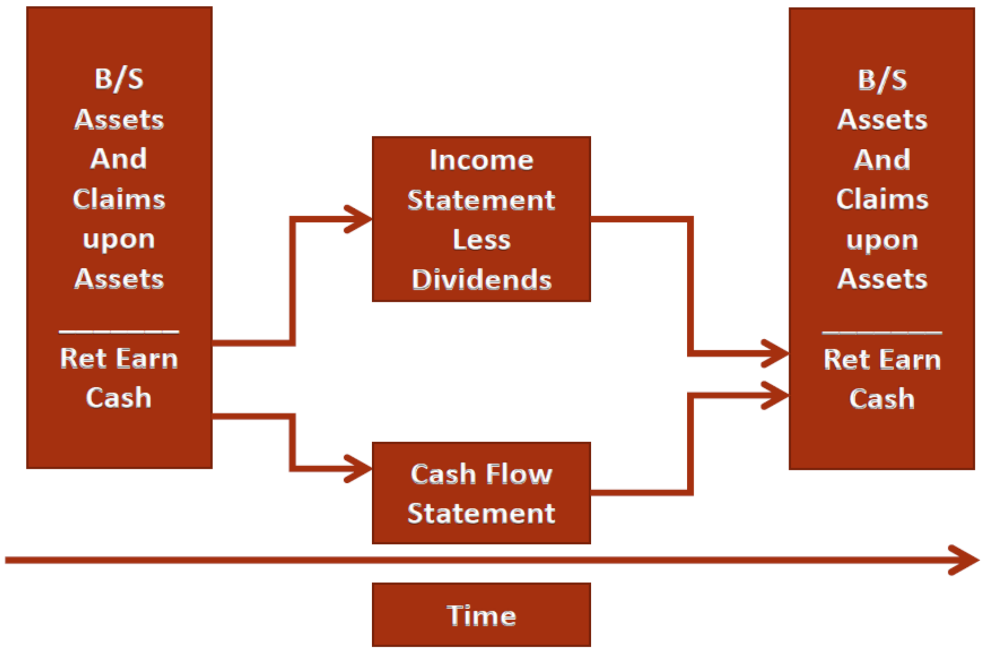
Accounting as history …



Note: Cash Flow and Income are likely to be complements rather than substitutes

Purpose of the Cash Flow Statement

A statement of cash flows:

o Shows relationship of net income to change in cash balances (through the cash flow from operating activities section)

o Helps to predict future cash flows

o Evaluates how management generates & also uses cash

o Determines a company's ability to pay interest, dividends & debts when they are due

o Identifies specific increases & decreases in a firm's productive assets

The term "cash" also refers to cash equivalents:

o Cash equivalents are highly liquid short-term investments that a company can easily and quickly convert to cash e.g.

✓ Money market funds

✓ Treasury bills

Typical Activities Affecting Cash

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Managers affect cash by three types of decisions:

- Operating decisions
- Investing decisions
- Financing decisions

Operating Activities

Operating decisions concerned with major day-to-day activities that generate revenues and expenses

Operating activities are transactions that affect the purchase, processing, and selling of a company's products and services

- Making sales
- Collecting accounts receivable
- Purchasing inventory
- Paying accounts payable

The first major section on the statement of cash flows is labelled **cash flows from operating activities**

Investing Activities

Investing decisions include the choices to acquire or dispose of long-term productive assets or long-term investments

Investing activities are transactions that acquire or dispose of assets that are expected to provide services for more than one year

- Purchasing or disposing of equipment

The investing section on the statement of cash flows is labelled **cash flows from investing activities**

Financing Activities

Financing decisions concerned with how to obtain or repay cash

Financing activities are a company's transactions that obtain resources from debt & equity transactions

- Issuance of additional share capital
- Borrowing money from the bank
- Repaying previous loans

The financing section on the statement of cash flows is labelled **cash flows from financing activities**

Typical Activities Affecting Cash

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Cash Inflows	Cash Outflows
Operating Activities:	
Collections from customers	Cash payments to suppliers
Interest and dividends collected	Cash payments to employees
Other operating receipts	Interest and taxes paid
	Other operating cash payments
Investing Activities:	
Sale of property, plant, and equipment	Purchase of property, plant, and equipment
Sale of securities that are not cash equivalents	Purchase of securities that are not cash equivalents
Receipt of loan repayments	Making loans
Financing:	
Borrowing cash from creditors	Repayment of amounts borrowed
Issuing equity securities	Repurchase of equity shares (including the purchase of treasury stock)
Issuing debt securities	Payment of dividends

N.B. IFRS permits entities to treat interest as a financing activity => CFO is ambiguous

The importance of cash flow

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The income statement matches revenue & expenses using accrual concepts & provides a measure of economic performance

The statement of cash flows explains changes in the cash account rather than owners' equity

Free cash flow:

- Finance measure of cash management performance
- Refers to cash flows from operations less capital expenditures (& sometimes less dividends)

Cash Flow from Operating Activities

Two approaches may be used:

- **Direct method**:
  - Subtracts operating cash disbursements from operating cash collections
  - Is preferred by the IASB/FASB
- **Indirect method**:
  - Adjusts accrual-based net income from the income statement to reflect only cash receipts and disbursements
  - Is used by most companies

Reconciliation Statement

IASB & FASB require direct-method statements to include a supplementary schedule reconciling net income to net cash provided by operations

In other words, companies that use the direct method must also prepare a report using the indirect method (reconciliation schedule)

As a result, most companies use the indirect method

IFRS vs US GAAP

IFRS allows preparers to choose to include **interest expense** as either a **financing activity** or an **operating activity**

US GAAP requires **interest expense** to be an **operating activity**

- Therefore, CFO not well defined under IFRS
- Be careful of this difference, particularly if using CFO to derive a Free Cash Flow measure for a valuation model

Conclusions

Income & cash flow are describing many of the same economic events – hence they are complements

The statement of cash flows is a key financial statement and CFO may be computed as a residual or by using the direct or indirect methods

Free cash flow is widely used as a measure of cash generating ability

Be careful with CFO under IFRS as it may (or may not) include cash flows for interest

Cash Flow Statement: Google

KEY POINTS:

- CFO is a ***laundry list*** of accrual-based adjustments that the accountant has put through the income statement

- Can construct estimates of Free Cash Flow directly from cash flow statement

- Why does Google hold so much cash ?

Statement of cash flows (IAS 7)

Important Definitions

"Cash": **Cash on hand and demand deposits**

o Bank borrowings generally deemed to be financing activities

o However, when bank overdrafts are repayable on demand they form an integral part of an entity's cash management & therefore should be included as a component of cash and cash equivalents.

"Cash Equivalents": Short-term highly liquid investments that are readily convertible to known amounts of cash & which are subject to **insignificant** risk of changes in value

o Held for the purpose of meeting short-term cash commitments & not for investment purposes

o An investment normally qualifies as a cash equivalent only when it is expected to mature within 3 months from the date of acquisition (**NB: not from the end of the reporting period**)

Presentation of Cash Flow Statement

All cash flows must be classified under one of 3 headings:

1) **Operating activities**

2) **Investing activities**

3) **Financing activities**

Note: A transaction could include cash flows that can be separated from classification into the above groups

1. Operating Activities

Cash flows from operating activities mainly derived from the principle revenue producing activities of an entity

They generally result from transactions & events which determine profit or loss

An entity has a choice in presenting cash flows from operating activities, it may either use:

I. **Direct Method** (use of this method encouraged by IAS 7)

OR

II. **Indirect Method** (we focus on this method for purposes of this module)

The Direct Method

This method shows:

- Receipts from customers
- Payments to suppliers for goods and services
- Cash payments to and on behalf of employees

The Indirect Method

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Under this method the net cash flow from operating activities determined by adjusting profit or loss by:

(a) Changes during the period in inventories, operating receivables & operating payables;

(b) Non-cash items in income statement

- e.g. depreciation, gains/losses on disposal of non-current assets, provisions, unrealised foreign currency gains and losses and undistributed profits of associates and non-controlling interest

2. Investing Activities

They are defined as the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Examples:

(a) Cash payments to acquire property, plant and equipment, intangibles and other long-term assets.

(b) Cash receipts from sale of property, plant and equipment, intangibles and other long-term assets.

(c) Payments to acquire equity or debt instruments in other entities (including associates) held as assets – N.B. do not include those instruments which qualify as cash equivalents.

(d) Cash receipts from selling investments in other entities as in (c).

(e) Cash advances and loans to other parties and cash receipts from repayment of those advances and loans.

3. Financing Activities

Those activities that result in changes in size & composition of the contributed equity & borrowings of an entity

Examples:

(a) Cash proceeds from the issue of shares or other equity instruments

(b) Cash payments to acquire or redeem the entity's shares

(c) Cash receipts from the issue of:

- Debentures
- Loans
- Short or long-term borrowings
- Bonds, etc.

(d) Cash repayments of amounts borrowed

(e) Capital portion of a finance lease rental payment

Reporting Cash Flows from Investing & Financing Activities

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General Rule:

Entities must report separately major classes of gross cash receipts and gross cash payments

Treatment of Interest & Dividends

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Cash flows from interest & dividends received & paid must each be disclosed separately

Each must be classified in a consistent manner from period to period

However, IAS 7 is not prescriptive in the treatment of interest and dividends

Treatment of Interest & Dividends

Interest Paid, Interest Received & Dividend Received:

Interest paid/received & dividends received may be classified as **OPERATING** cash flows because they are included in the calculation of profit or loss

OR

May be included under **FINANCING** activities & **INVESTING** activities because they are costs of obtaining financial resources or returns on investments

Treatment of Interest & Dividends

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Dividend Paid:

Dividends paid may be classified as a **FINANCING** cash flow - a cost of obtaining financial resources

OR

❖ Can be included as a component of **OPERATING** cash flows in order to assist users of financial statements to determine the ability of the reporting entity to pay dividends out of operating cash flows.

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