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Cash Flow Statement IAS 7

Cash flow statement may provide considerable information about what is really happening in a business beyond that contained in either the income statement or the balance sheet. Analyzing this statement should not present an intimidating task; instead it will quickly become obvious that the benefits of understanding the sources and uses of a company's cash far outweigh the costs of undertaking some very straightforward analyses. Thus, management of cash is very essential. There should be focus on movement of cash and its equivalents. Cash means, cash in hand and demand deposits with the bank. Cash equivalent consists of bank overdraft, cash credit, short term deposits and marketable securities.

Cash Flow Statement deals with flow of cash which includes cash equivalents as well as cash. This statement is additional information to the users of Financial Statements. The statement shows the incoming and outgoing of cash. The statement assesses the capability of the enterprise to generate cash and utilize it. ***Thus a Cash-Flow statement may be defined as a summary of receipts and disbursements of cash for a particular period of time. It also explains reasons for the changes in cash position of the firm.***

Cash flows are cash inflows and outflows. Transactions which increase the cash position of the entity are called as inflows of cash and those which decrease the cash position as outflows of cash. Cash flow Statement traces the various sources which bring in cash such as cash from operating activities, sale of current and fixed assets, issue of share capital and debentures etc. and applications which cause outflow of cash such as loss from operations, purchase of current and fixed assets, redemption of debentures, preference shares and other long-term debt for cash. In short, a cash flow statement shows the cash receipts and disbursements during a certain period. The statement of cash flow serves a number of objectives which are as follows:

- Cash flow statement aims at highlighting the cash generated from operating activities.
- Cash flow statement **helps in planning the repayment of loan** schedule and replacement of fixed assets, etc.
- Cash is the centre of all financial decisions. It is used as the basis for

the projection of future investing and financing plans of the enterprise.

- Cash flow statement helps to ascertain the liquid position of the firm in a better manner. Banks and financial institutions mostly prefer cash flow statement to analyse liquidity of the borrowing firm.
- Cash flow Statement helps in efficient and effective management of cash.
- The management generally looks into cash flow statements to understand the internally generated cash which is best utilised for payment of dividends.

Who cares about a Cash Flow Statement?

- **Executives** want to know if the cash generated by the company will be sufficient to fund their expansion strategy
- **Stockholders** want to know if the firm is generating enough cash to pay dividends
- **Suppliers** want to know if their customers will be able to pay if offered credit
- **Investors** want to evaluate future growth potential
- **Employees** are interested in the overall viability of their employer as indicated by its ability to fund its operations

Format of the Cash Flow Statement

There are two formats of preparing the Cash Flow Statement. How ever the two yield the same results

The direct method
The direct method shows operating cash receipts and payments, for example, cash paid to suppliers and employees and cash received from customers. This is useful to users as it shows the actual sources and uses of cash. However, many entities will not generate this information as a matter of course and so it may prove expensive to produce.

The indirect method
The indirect method instead starts with profit before taxation, adding back items shown elsewhere on the cash flow statement (e.g. finance cost) and adjusting for non-cash items included in arriving at the operating profit figure. Non-cash items would include the following:

- *Depreciation*:

this is a book adjustment to reflect the wearing out of an asset; the cash impact of non-current assets is the buying of the asset.

• *Profits/losses on disposal of non-current assets*:
Profit is not cash – the cash impact of the disposals the disposal proceeds.

• *Changes in inventories*:
Because operating profit is calculated after charging cost of sales, which has been adjusted for opening and closing inventory; we need the figure for total cash spent on materials in the year, not the cost of the goods used in the year.

• *Changes in receivables*:
The figure included in the income statement is the sales revenue – we need the cash received from customers and so we must take account of opening and closing receivables for the year.

• *Changes in payables*:
For the same reason as above – we need to get to the figure for actual cash paid to suppliers. Entities are required to disclose the calculation using the indirect method as it provides the reconciliation of operating profit to cash flows from operating activities, which is an integral part of the cash flow statement (it is therefore more likely to be the indirect method that is requested in examination, but the direct method will occasionally be examined).

- The cash flow statement is divided into three sections:
  - o ***Cash flow from operating activities:***
    Shows the results of cash inflows and outflows related to the fundamental operations of the basic line or lines of business in which the company engages. (Example: cash receipts from the sale of goods or services and cash outflows for purchasing inventory and paying rent and taxes.)
  - o ***Cash flow from investing activities:***
    Associated with purchases and sales of non-current assets (Example: building and equipment purchases or sales of investments or subsidiaries.)
  - o **Cash flow from financing activities:**
    Associated with financing the firm (Example: selling and paying off bonds and issuing stock and paying dividends)

Examples of cash flows from operating activities are:
(a) Cash receipts from the sale of goods and the rendering of services;
(b) Cash receipts from royalties, fees, commissions and other revenue;
(c) Cash payments to suppliers for goods and services;
(d) Cash payments to and on behalf of employees;

(e) Cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;
(f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
(g) Cash receipts and payments from contracts held for dealing or trading purposes.
Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

Investing Activities

Cash inflow	*Cash outflow*
Sale of fixed assets	Purchase of fixed assets
Sale of investment	Purchase of investment
Interest received	
Dividend received	

Financing Activities

Cash inflows	*Cash outflows*
Issue of shares	Cash repayments of amounts borrowed
Issue of debentures in cash	Dividends paid on equity and preference share capital
Proceeds from long term/ short term borrowings	Interest paid on loans/debentures

- Exceptions
  - Short-term marketable securities are treated as long-term investments and appear in cash flow from investing activities
  - Short-term debt is treated as long-term debt and appears in cash flow from financing activities
  - Although dividends are handled as a cash outflow in the cash flow from financing activities section, interest payments are considered an operating outflow, despite the fact that both are payments to outsiders for using their money.

Example of a Statement of Cash Flow: notice how it separates the three different cash flow activities

ABC LTD
Statement of Cash Flows
For the year ended 31 December 20xx

Cash Flow from Operating Activities		
Net Income	XXX,XXX	
Adjustments to reconcile net income to net Cash provided by operating activities:		
Depreciation and amortization	XX,XXX	
Gain on sale of investment/ ASSET	(X,XXX)	
Changes in other accounts affecting operations:		
(Increase)/ decrease in accounts receivable	X,XXX	
(Increase)/ decrease in inventories	X,XXX	
(Increase)/ decrease in prepaid expenses	X,XXX	
Increase/ (decrease) in accounts payable	X,XXX	
Increase/ (decrease) in taxes payable	X,XXX	
Net cash provided by operating activities		**XXXXX**
Cash Flow from Investing Activities		
Capital expenditures	(XXX,XXX)	
Proceeds from sales of equipment	XX,XXX	
Proceeds from sales of investments	XX,XXX	
Investments in subsidiary	(XXX,XXX)	
Net cash provided by investing activities		**XXXX**
Cash Flow from Financing Activities		
Payments of long-term debt	(XX,XXX)	
Proceeds from issuance of long-term debt	XX,XXX	
Proceeds from issuance of common stock	XXX,XXX	
Dividends paid	(XX,XXX)	
Purchase of treasury stock	(XX,XXX)	
Net cash provided by financing activities		**XXXXX**
Increase (Decrease) in Cash		**XXX,XXX**
Cash at the beginning of the period		**XXX**
Cash at the END of the period		**XXX**
		======

- Operating Activities:
  - o The cash flow from operating activities section of a cash flow statement can be presented using the direct format or the indirect

format. The bottom line is the same, but the two begin at different points. Companies are free to use either format.

Below is an example of both formats.

o Direct method:

Shows how much cash came in for sales and how much cash went out for inventory and other operating expenditures.

o Indirect method:

Starts with net income as a figure that summarizes most of the cash transactions for operating activities in a firm. However, net income also includes transactions that ere not cash, so we must eliminate the non-cash transactions from the net income figure to arrive at an accurate presentation of cash flow from operating activities.

E& H LTD had the following statements for the year ended Dec 31, 2010 and 2009

E& H LTD

Income statement

For the year ended December 31

	Sh	Sh
Revenues		2,200,000
Gain on sale of investment		5,000
Expenses:		
Cost of goods sold	1,100, 000	
Operating expenses	450,000	
Depreciation expenses	25,000	
Income tax expense	217,000	
Total expenses		1,792,000
Net income		413,000