

CAT 6 (INT)

DRAFTING FINANCIAL STATEMENTS

CERTIFIED ACCOUNTING TECHNICIAN



STUDY TEXT



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STUDY GUIDE 3: STATEMENT OF CASH FLOWS

Get Through Intro

Statements of cash flows are included as a component of financial statements under IAS 1 Presentation of Financial Statements.

Until recently the phrase 'financial statements' indicated mainly the SOFP (balance sheet) and the SOCI (income statement) (profit and loss account). However, these two statements by themselves do not give vital information necessary for an understanding of the performance and the health of an entity.

Cash is the lifeline of a business and it is essential that the owners and other users have sufficient information about its movements. Failure to manage cash properly may snap that lifeline, endangering the survival of the business.

In the future, as an accountant, consultant or auditor, you may be called upon to prepare or verify statements of cash flows. Company management or client's should be able to place their faith in these and take important decisions based on them. This Study Guide helps you to gear up for this challenge.

Learning Outcomes

- a) Explain the need for a statement of cash flows.
- b) Prepare a statement of cash flows including relevant notes for a single company in accordance with accounting standards.
- c) Appraise the usefulness of, and interpret the information in a statement of cash flows.

Introduction



Case Study

Nevilon, a company, earned profits worth \$1m according to its SOCI (income statement). It still faced a liquidity crisis and eventually a creditor started liquidation proceedings.

The directors were puzzled by this paradox. How can a company earning healthy profits face a liquidity crisis?

On investigation, it was revealed that it did not realise the profit in cash; the profit was blocked in its receivables and inventory, which it could not convert into cash in time. This can be known only when a Statement of Cash Flows is prepared.

The statement of cash flows, in conjunction with the rest of the financial statements, provides for these missing links and gives details of cash flows i.e. how much has been received, how it has been spent, and how much is in hand. Thus the statement of cash flows is now considered an integral part of the financial statements.

In this Study Guide, we explain the basic concepts, techniques of preparation, usefulness and interpretation of statements of cash flows.

1. Explain the need for a statement of cash flows.

[Learning outcome a]

Management has to plan the future cash flows and control the present ones. Both these tasks are not possible unless data regarding cash flows is available. This information is available in the statement of cash flows.

1.1 The importance of information on cash flows

1. Cash is the lifeline for any business. Cash is needed regularly for all activities. If adequate cash is not available on time, the **day-to-day operations may be hampered**. Management has to plan the cash flow for the future and initiate steps to raise finance in advance, if required.
2. The **survival of an entity depends upon its ability to generate cash** from operations (not only to show book profits). For example, profit which is tied up in a large amount of inventories may weaken the liquidity position of the company, as all its cash is invested in its inventories. Management has to monitor cash flow on daily basis.
3. For the same reasons, **trade payables and banks are interested in cash flow figures**. They want to know the repayment capacity of the entity. Management has to remember that their performance will also be judged from this angle and ensure good cash flow management.
4. Bad cash management can also **adversely affect profitability**. If a large amount of cash is kept idle, it does not earn any income. Similarly if an amount due from receivables is not collected on time, cash is tied up in receivables. The same cash can be employed more profitably in an alternative opportunity.

However, having too little cash may endanger the solvency of an entity. Therefore, management has to strike a balance between profitability and liquidity. The two have opposite pulls. More liquidity (having more cash) means less profitability.

To maintain the balance amongst the profitability and liquidity of the entity the management should keep control over the cash flows of the entity, which **could only be effectively possible with the help of a statement of cash flows**.

Diagram 1: Balance between profitability and liquidity



Test Yourself 1

State any three reasons why management has to control cash.

2. Prepare a statement of cash flows including relevant notes for a single company in accordance with accounting standards.

[Learning outcome b]

Cash flow means a flow of cash and cash equivalents. When the opening and closing balance is calculated for the Statement of Cash Flows, a total of cash and cash equivalents are considered.

The movements between any two components of cash and cash equivalents are not treated as cash flows and therefore not reported in a statement of cash flows. They represent the internal changes to the group of cash and cash equivalents.

Therefore before we move on to the preparation of the statement of cash flows; it is important that we understand the meaning of cash and cash equivalents.

2.1 Cash and cash equivalents

Definitions



Definition

Cash comprises cash in hand and demand deposits.

IAS 7 para 6



Definition

Cash equivalents are short-term, highly liquid investments that are **readily convertible to known amounts of cash** and are subject to an **insignificant risk of a change in value**.

IAS 7 para 6

Cash equivalents enable the entity to meet **short-term cash commitments**. For an investment to be treated as a cash equivalent, the following conditions should be met.

1. It should be readily convertible into cash.
2. It has a short maturity period, e.g. **less than three months**.
3. There should be no significant risks of changes in the value to be realised.

Equity / share instruments are generally excluded from cash equivalents, unless they are, in substance, cash equivalents.

Example

Preference shares acquired within a short period (3m) of their maturity may be treated as cash equivalents.

Bank borrowings are generally excluded from cash equivalents, unless they are repayable on demand.

Example

Bank overdrafts repayable on demand are treated as part of cash equivalents.

An entity has to **disclose** the **components of the cash and cash equivalents**. It also has to present a reconciliation of this amount with the cash balance disclosed in the statement of financial position.

Example

Perfect Co's statement of cash flows shows a balance of cash and cash equivalents at the year end of \$40m. In its statement of financial position, the bank and cash balance is disclosed as \$25m. It must show how the figure of \$40m was arrived at. For example, if an amount of investments of a short maturity period, worth \$15 m are treated as a cash equivalent, then Perfect Co will disclose the composition of cash and cash equivalents as:

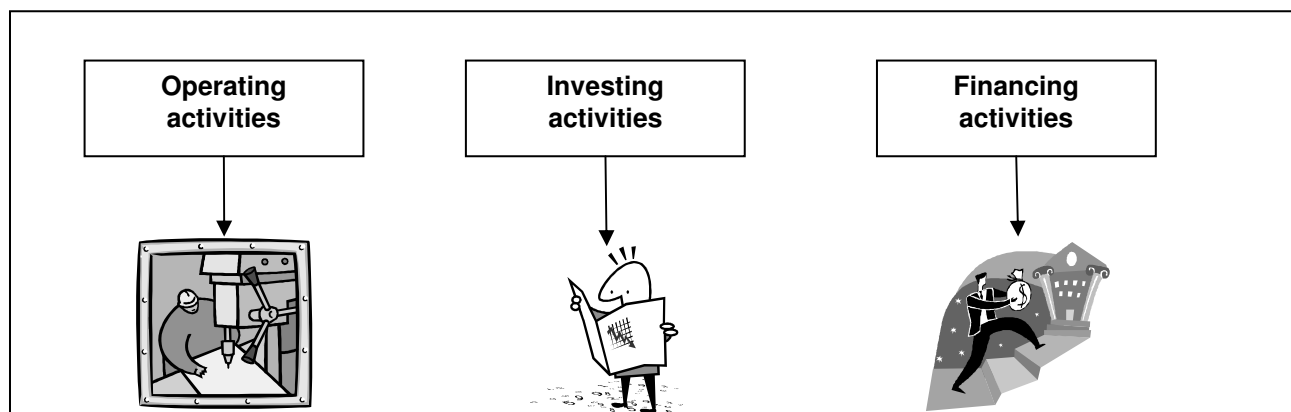
	\$m
Cash and bank balance	25
Investments with a maturity of less than 3 months	15
Total	40

This will help readers to analyse the statement of cash flows and the statement of financial position together.

2.2 General principles for the classification of cash flows.

The effect of any transactions can be classified under any one of the following categories:

1. Operating activities
2. Investing activities
3. Financing activities



The statement of cash flows breaks the overall cash flow into these activities. This makes the presentation more meaningful.

1. Operating activities



Definition

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

IAS 7 para 6

Generally, cash receipts or payments for all items in the SOCI (income statement) will be included to calculate cash flows from operating activities.

Examples of cash flows from operating activities, as given by the IAS:

- 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 payments or refunds of income tax

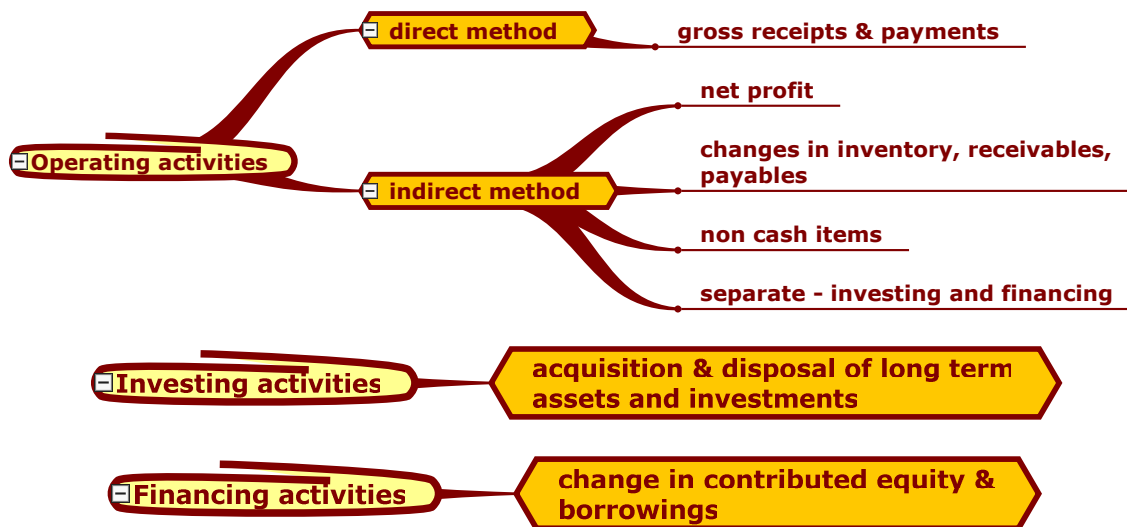
Disclosure of the cash flows from operating activities will enable the users to **judge whether the entity is fulfilling the main purpose for which it exists**, i.e. to earn sufficient money from the principal revenue-producing activities in order to run the company, pay dividends, repay loans, make new investments etc.

Example

Nest Ltd's statement of cash flows shows that it earns cash worth \$25m from operations. It pays dividends of \$15m, repays a loan worth \$22m, has taken out a new loan of \$13m, and makes new investments of \$1m. Information in its financial statements shows that the repayment of \$22m is towards outstanding normal loan instalments.

The statement of cash flows shows that Nest Ltd is not earning sufficient cash from operations. It has to use money from a fresh borrowing to repay the earlier loan. (Out of \$25m cash from operations, \$15m is paid as dividends, leaving only \$10 m for other purposes, which is not sufficient for loan repayments.)

SUMMARY



2. Investing activities



Definition

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

IAS 7 para 6

This group of activities indicates the extent to which the entity invests in activities which will bring benefits in the future.

Example

If money is invested in new machinery, it will help the entity to produce and sell more goods, which in turn will generate more income in the future.

The cash payments or receipts on account of the following are treated as cash flows from investing activities:

- Property, plant and equipment, intangibles and other long-term assets e.g. acquisition or disposal of equipment.
- Shares or debt of other entities (excluding those forming part of cash equivalents or held for trading) e.g. acquisition / disposal of ordinary shares.
- Cash advances and loans made to other parties (other than those made by a financial institution) e.g. Star Co, a manufacturing company gives a loan of \$80,000 to Moon Co.

3. Financing activities



Definition

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

IAS 7 para 6

This includes the following cash receipts and payments:

- a) Issue or redemption of shares.
- b) Borrowing and repayment of debentures, loans, notes, bonds, mortgages and other short or long-term borrowings.
- c) Cash payments towards the principal portion by the lessee of a financial lease.

The information under this group of activities helps the readers to know how the entity has raised or repaid the financial resources. These details help in predicting claims on future cash flows by providers of capital to the entity.

Example

Ingrid Plc raised \$500,000 by issuing shares and \$200,000 by way of fixed term loans from banks. It invested \$400,000 in a building and \$300,000 in plant and equipment.

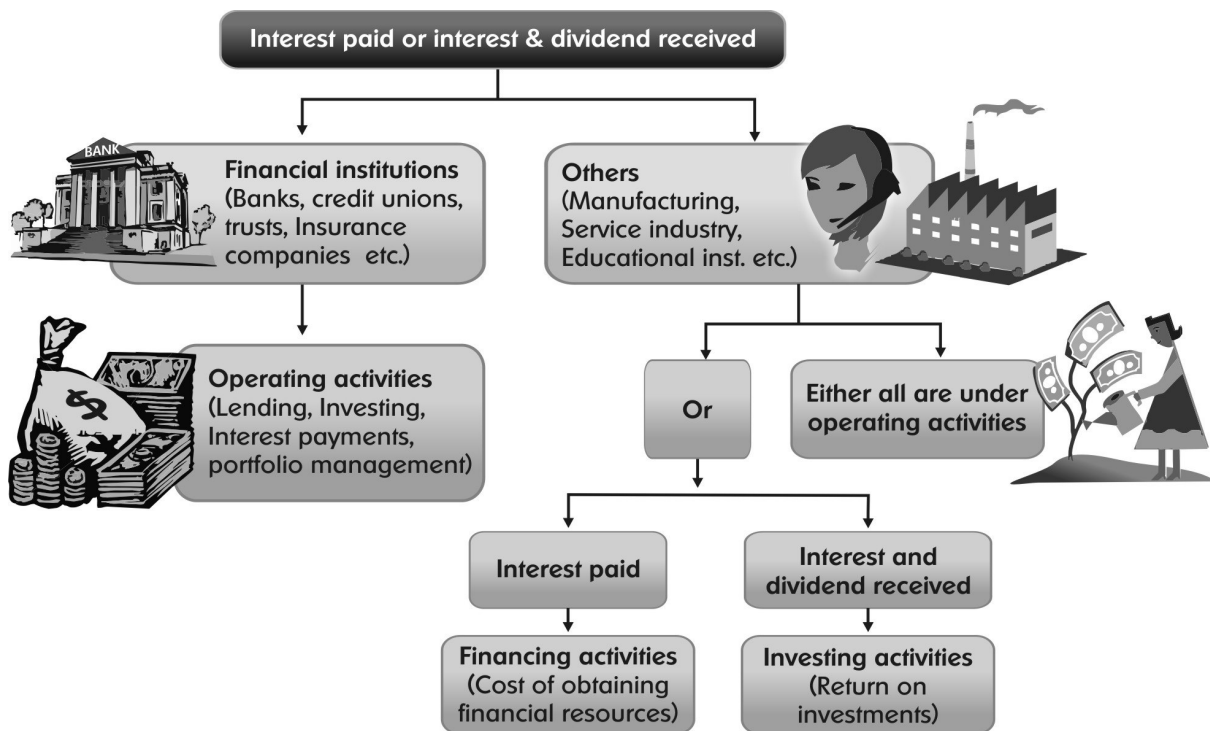
Raising money by issuing shares or bank loans is a financing activity and these are shown as cash inflows under this category.

Similarly, investing money in buildings and plant and equipment is an investing activity and is disclosed as cash outflows under this category.

2.3 Classification of certain specific items:

1. Classification of interest paid and interest and dividend received.

Diagram 2: Interest paid or interest and dividend received for financial institutions and others

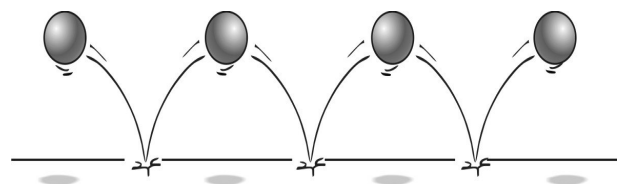


2. Classification of dividends paid

Dividends paid:		
Classified as financing activities	OR	Classified as operating activities
As it is cost of obtaining financial resources		To assess whether the entity is able to pay dividends out of operating activities

3. Consistency

As seen above, it may be possible to classify interest and dividends under operating, investing or financing activities. There should be a consistency in classifying and disclosing them under operating, investing or financing activities.



4. Taxation on income

Cash outflows arising from tax on income should be separately disclosed and classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Test Yourself 2

Identify the classification of the following activities in order to prepare a statement of cash flows.

- Issue of share capital for cash
- Issue of share capital other than cash, for acquisition of business
- Payment to suppliers
- Depreciation
- Purchase of a plant
- Dividend paid
- Tax on income

2.4 Direct \ indirect method



Important

An entity should report cash flows from **operating activities** using either:

- The **direct method**, whereby major classes of gross cash receipts and gross cash payments are disclosed;
- The **indirect method**, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments and items of income or expense associated with investing or financing cash flows.

IAS 7 para 18

1. Direct method – gross receipts and payments

The standard recommends this method, because it provides information which may be useful to estimate future cash flows.

The information under major classes of **gross receipts and payments of cash** may be obtained either:

- directly from the accounting records; or
- taking the SOCI (income statement) as the basis and adjusting the figures for sales, cost of sales and other items for:
 - changes during the period in inventories and operating receivables and payables;
 - other non-cash items; and
 - other items for which the cash effects are investing or financing cash.

Proforma of Statement of cash flows using the direct method (with imaginary figures)

Cash flows from operating activities	\$'000	\$'000
Cash receipts from customers	5,000	
Cash paid to suppliers and employees	(4,000)	
Cash generated from operations	1,000	
Interest paid	(200)	
Income taxes paid	(250)	
Net cash from operating activities		550
Cash flows from investing activities		
Purchase of property, plant and equipment	(300)	
Proceeds from sale of equipment	40	
Interest received	30	
Dividends received	20	
Net cash used in investing activities		(210)
Cash flows from financing activities		
Proceeds from issue of share capital	700	
Proceeds from / (repayments of) long-term borrowings	(300)	
Payment of finance lease liabilities	(200)	
Dividends paid	(400)	
Net cash used in financing activities		(200)
Net increase in cash and cash equivalents (550 – 210 – 200)		140
Cash and cash equivalents at beginning of period		50
Cash and cash equivalents at end of period		190

Example

Sales in the SOCI (income statement) are \$25m, the increase in the receivables is \$2m (opening balance = \$3m, closing = \$5m). What is the figure for the amounts collected from receivables?

Total Receivables Account

Dr		\$m			\$m	Cr
01/01/20X8	Balance b/f	3			Cash collections (balancing figure)	23
	Sales	25	31/12/20X8		Balance c/f	5
	Total	28			Total	28

In the above example, the balance of receivables brought forward was \$3m. Additional sales (assumed to be credit sales) were \$25m. This makes the total receivables \$28m.

However, at the end of the year, \$5m out of this was outstanding; thus $28 - 5 = \$23\text{m}$ was received from customers.

We can make a simplified rule from the above: if receivables increase, more money is tied up in receivables and less cash is received. Therefore **an increase in receivables** (or inventory) **causes a reduction in the inflow from operating activities**. (Indirectly, this may also be called an outflow) By the same logic, **a decrease in these assets will increase the inflow**.

Example

The opening balance on trade payables was \$2m. The closing balance was \$1m. If purchases during the year were \$18m, what was the actual amount paid to suppliers?

Total Payables Account

Dr		\$m			\$m	Cr
31/12/20X8	Payments (balancing figure)	19	01/01/20X8	Balance b/f		2
	Total	20		Purchases		18
				Total		20

The outflow is \$19m whereas purchases were only \$18m. The outflow is higher because of a decrease in the liability of \$1m (opening 2 – closing 1).

Thus, a decrease in the liability will be an outflow; conversely, an increase in liability will be inflow.

Direct Method	Indirect Method
1. Prepare a proforma	
2. Determine the figure for net profit in order to calculate net cash flows from operating activities.	
a) If using the direct method:	b) If using the indirect method:
i. Find out cash received from customers and cash paid to suppliers and employees.	i. If the profit figure is not given, calculate it by preparing the SOCI (income statement) or in some other suitable manner.
ii. Deduct interest paid and income tax paid.	ii. Start with net profit.
	iii. Add back non-cash expenses such as depreciation.
	iv. Add the write-off of intangible assets and deduct non-cash income and any non-cash write-back of liabilities.
	v. Eliminate items to be disclosed under other headings e.g. income from investments.
c) Find out the amount of tax paid (if not available separately) since it is to be separately disclosed. If sufficient information is not given, then you may assume that the previous year's provision has been paid off during the year.	
3. Calculate cash flows on account of investing activities.	
4. Calculate cash flows on account of financing activities.	
5. As in the preparation of the final accounts from the trial balance, ensure that you consider, one by one:	
a) All SOFP (balance sheet) items, appropriately treating the differences between the opening and closing balance.	
b) Check whether the items which need a separate disclosure are applicable in the given case e.g. dividends paid, income tax paid.	

6. Put in the figures calculated (as above) and then recheck if any figures are missing.
7. Remember to reconcile the opening, closing cash and cash equivalents with the SOFP (balance sheet) items.
8. The difference between the opening and closing balance of cash and cash equivalents (as reconciled with the SOFP (balance sheet) should be exactly equal to the net increase or decrease in cash and cash equivalents as shown in the statement of cash flows. This will confirm the arithmetical accuracy of the cash flow.
9. Give sufficient workings for the important calculations made but not reflected directly in the statement of cash flows.

Example

From the following details, prepare a statement of cash flows for the year ended 31 March 20X8:

	\$
Total sales for the year were \$949,000, which included cash sales worth	586,000
Cash collections from credit customers during the year	623,400
Cash paid to suppliers and employees	796,810
Income tax paid	187,500
Fully paid debentures redeemed at a premium of 2%, with a face value of	100,000
Interest on debentures	8,400

Furniture with a book value of \$10,500 was disposed of for \$6,100. New furniture valued at \$8,160 was purchased.

	\$
Dividends for the year ended 31 March 20X7 distributed during 20X7-20X8	45,000
On 31 March 20X8 cash in hand and at bank totalled	81,000



Answer Plan

- The information available is suitable for the direct method.
- Prepare a proforma for the direct method.
- Classify the activities under operating, financing and investing activities.
- Enter the figures in the proforma format.

Answer

Direct method statement of cash flows

	\$	\$
Cash flows from operating activities		
Cash receipts from customers (586,000 + 623,400)	1,209,400	
Cash paid to suppliers and employees	(796,810)	
Cash generated from operations		412,590
Interest paid		(8,400)
Income tax paid		(187,500)
Net cash from operating activities		216,690
Cash flows from investing activities:		
Purchase of property, plant and equipment	(8,160)	
Proceeds from sale of equipment	6,100	
Net cash used in investing activities		(2,060)
Cash flows from financing activities		
Proceeds from long-term borrowings – redemption of	(102,000)	
Dividends paid	(45,000)	
Net cash used in financing activities		(147,000)
Net increase in cash and cash equivalents		67,630
Cash and cash equivalents at beginning of period *		13,370
Cash and cash equivalents at end of period		81,000

* Not given; therefore calculated as a balancing figure

Test Yourself 3

From the following details of Rock Plc, calculate the cash flow from operating activities, using the direct method.

	\$
Cash sales	800,000
Balance of trade receivables at 1 April 20X7	500,000
Credit sales	4,270,000
Balance of trade receivables at 31 March 20X8	570,000
Cash paid to employees	600,000
Cash purchases	200,000
Balance of trade payables at 1 April 20X7	300,000
Credit purchases	3,250,000
Balance of trade payables at 31 March 20X8	350,000
Interest paid	200,000
Income taxes paid	250,000

2. Indirect method

This method is easier, faster, cheaper and therefore preferred by many companies.

a. Net profit

The net profit or loss from the SOCI (income statement) is taken as a starting figure, **and adjustments are made** for the effects of the following items.

b. Non-cash items

Items such as depreciation and provisions may appear in the SOCI (income statement) but do not represent cash flow. The net profit / loss taken as the starting figure includes the effect of all of these. Hence we need to eliminate them.

Take the case of depreciation. The asset on which depreciation is charged was purchased in the past. When we disclose depreciation as an expense in the SOCI (income statement), we charge an expense for which there is no cash flow in the current year.

Example

Game Ltd's SOCI (income statement) shows a net profit of \$75m after charging depreciation of \$8m and recognising a \$4m exchange gain on translation of a foreign operation.

Analysis of the profit is given below:

A	Cash operating profit	??
B	Add: Unrealised operating income	4
C	Less: Depreciation (non-cash expense)	(8)
D	Net profit	75

Algebraically, $A + B - C = D$. In this case, since A is not given, we move B and C to right-hand side, and get

$$\begin{aligned}
 A &= D - B + C \\
 &= 75 - 4 + 8 \\
 &= 79
 \end{aligned}$$



Important

We can now generalise the rule as:

If we start with the net profit figure, we **add all the non-cash expenses and deduct all non-cash incomes**.

Proforma of statement of cash flows using the indirect method (with imaginary figures)

Cash flows from operating activities		
	\$'000	\$'000
Profit before taxation	640	
Adjustments for		
Depreciation	90	
Loss on sale of non-current assets	30	
Investment income	(20)	
Interest expense	200	
	940	
Decrease / (Increase) in trade and other receivables	(70)	
Decrease / (Increase) in inventories	80	
Increase / (Decrease) in trade payables	50	
Cash generated from operations	1,000	
Interest paid	(200)	
Income tax paid	(250)	
Net cash from operating activities		550
Cash flows from investing activities		
Purchase of property, plant and equipment	(300)	
Proceeds from sale of equipment	40	
Interest received	30	
Dividends received	20	
Net cash received from / (used in) investing activities		(210)
Cash flows from financing activities		
Proceeds from issue of share capital	700	
Proceeds from / (repayments of) long-term borrowings	(300)	
Payment of finance lease liabilities	(200)	
Dividends paid	(400)	
Net cash received from / (used in) financing activities		(200)
Net increase / (decrease) in cash and cash equivalents (550 – 210 – 200)		140
Cash and cash equivalents at beginning of period		50
Cash and cash equivalents at end of period		190

i. Separate the investing and financing components

Net profit will include the effects of gains or losses on account of investing and financing activities. Remember, investing activities are shown separately, so we need to remove these items from the operating activities. We do this by adjusting the net profit.

Example

The net cash profit of Large Company is \$7m after a profit of \$0.6m on the disposal of a machine with a carrying value of \$1m.

Since the cash flow from the disposal of a machine is a cash flow from investing activities, we need to separate the profit on disposal of machinery from the figure for net profit.

Thus, cash from operating activities would be calculated as:

	\$
Net profit	7.0
Less: profit on disposal of machinery	(0.6)
Cash from operating activities	6.4

As we will see in the next section, the total cash received from the disposal of the machine, i.e. \$1.6m (1.0 + 0.6), will be shown as a cash inflow from investing activities.

ii. Changes in inventory, receivables and payables

We will summarise the relationship between assets and liabilities with the cash flows.

- increase in asset indicates outflow of cash
- decrease in asset indicates inflow of cash
- increase in liability indicates inflow of cash
- decrease in liability indicates outflow of cash

Example

The cash profit of an entity was \$500,000. Inventory on 1 January 20X8 was \$120,000 and on 31 December 20X8 was \$160,000.

Out of the cash profit of \$500,000, an amount of \$40,000 (i.e. 160,000 – 120,000) was tied up in the additional inventory. This means that the net cash flow from operating activities was 500,000 – 40,000 = \$460,000.

c. Steps to be used to solve problems in preparing a statement of cash flows

Now, let us review how to put the entire statement of cash flows together:

Example

The following figures have been extracted from Souffle Ltd's books for the year ended 31st March 20X8:

	\$
i. Net profit before income tax, after considering the following items:	3,066,980
a) Depreciation on property, plant & equipment	806,400
b) Discount on issue of debentures written off	56,000
c) Interest on debentures paid	504,000
d) Profit on sale of investments	15,400
e) Interest received on investments	70,000
f) Compensation received in a lawsuit	112,000
ii. Income tax paid during the year	1,540,000
iii. Book value of investments sold	343,000
iv. Nominal value of preference shares redeemed at a premium of 5%	2,100,000
v. Nominal value of equity shares issued for cash at a premium of 20%	700,000
vi. Dividends paid for the year 20X6-X7	840,000
vii. Interim dividends paid for 20X7-X8	280,000
viii. Land purchased (payment made by way of 560,000 equity shares of \$1 each issued at a premium of 20%)	672,000
ix. Current assets and current liabilities in the beginning and end of year	

	As at 31/03/20X7 (\$)	As at 31/03/20X8 (\$)
Inventory	1,740,200	1,905,400
Trade receivables	291,900	300,440
Cash in hand	26,600	35,420
Cash at bank	261,800	?
Bills receivable	98,000	84,000
Bills payable	77,000	70,000
Trade payables	233,940	241,360
Outstanding expenses	106,960	116,480

Continued on next page

Prepare statement of cash flows for the year ended 31 March 20X8.



Answer Plan

- The details given are suitable for the indirect format. Therefore, this format can be prepared.
- Decide on the classification of each item.
- Adjust the items included in the net profit but not forming part of the operating activities.
- Find out the difference between the opening and closing balance of the assets given, and enter them in the cash flow (see workings 1 and 2).
- Write the items in the correct place in the Statement of Cash Flows.
- Find out the total balance of cash equivalents at the end. Out of this total, the cash balance is known. The balancing figure will be the bank balance.

Answer

The statement of cash flows using indirect method

	\$	\$
Cash flows from operating activities		
Profit before taxation	3,066,980	
Adjustments for:		
Depreciation	806,400	
Investment income	(70,000)	
Profit on sale of investments	(15,400)	
Interest expense	504,000	
Discount on issue of debentures written off	56,000	
Decrease / (Increase) in trade and other receivables (W1)	5,460	
Decrease / (Increase) in inventories	(165,200)	
Increase / (Decrease) in trade and other payables (W2)	9,940	
Cash generated from operations	4,198,180	
Interest paid	(504,000)	
Income taxes paid	(1,540,000)	
Net cash from operating activities		2,154,180
Cash flows from investing activities		
Proceeds from sale of investments (\$343,000 + \$15,400)	358,400	
Interest received on investments	70,000	
Net cash received from / (used in) investing activities		428,400
Cash flows from financing activities		
Proceeds from issue of share capital (\$700,000 + 20%)	840,000	
Redemption of preference shares (\$2,100,000 + 5%)	(2,205,000)	
Dividends paid (\$840,000 + \$280,000)	(1,120,000)	
Net cash received from / (used in) financing activities		(2,485,000)
Net increase / (decrease) in cash and cash equivalents		97,580
Cash and cash equivalents at beginning of period (\$26,600 + \$261,800)		288,400
Cash and cash equivalents at end of period		385,980

The cash balance is \$35,420, therefore the bank balance = \$280,560

Workings

W1 Decrease in trade and other receivables:

	\$
Decrease in bills receivable (\$98,000 – \$84,000)	14,000
Increase in trade receivables (\$300,440 – \$291,900)	(8,540)
	5,460

Continued on next page

W2 Increase in trade and other payables:

	\$
Decrease in bills payable (\$77,000 – \$70,000)	(7,000)
Increase in trade payables (\$241,360 – \$233,940)	7,420
Increase in outstanding expenses (\$116,480 – \$106,960)	9,520
	9,940

Notes:

1. It is assumed that the lawsuit relates to operating activities, and hence no adjustment is made to remove its effect from them.
2. The above cash flow does not include the purchase of land worth \$672,000 due to the issue of 560,000 shares of \$1 each at a premium of 20%, since it is a non-cash transaction.

Test Yourself 4

From the following particulars of Rare Plc, calculate the cash flow from operating activities, using the indirect method:

	\$
Profit before tax	640,000
Included in this are the following:	
Depreciation	90,000
Development expenses written off	30,000
Investment income	20,000
Interest	200,000
Income tax paid	250,000
Balance of trade receivables at 1 April	500,000
Balance of trade receivables at 31 March	570,000
Balance of trade payables at 1 April	300,000
Balance of trade payables at 31 March	350,000
Balance of inventories at 1 April 20X7	400,000
Balance of inventories at 31 March 20X8	320,000

Review the changes in the receivables and payables against the rules set out earlier.

3. Appraise the usefulness of, and interpret the information in a statement of cash flows. [Learning outcome c]

3.1 Benefits of the statement of cash flows

1. The statement of cash flows enhances the comparability of the operating performance of two entities or two periods by eliminating the effects of using different accounting treatments for the same transactions and events.

Example

Simple and Style are similar entities with similar sales and net assets. Simple has a profit after depreciation of \$50m and Style, \$48m. The depreciation charged by them is \$5m and \$10m respectively. Which entity has higher cash flows?

The statement of cash flows will tell you that the cash inflow from the operating activities was \$55m (50 + 5) in the case of Simple and \$58m (48 + 10) in the case of Style, therefore Style's cash flows were higher.

2. The **survival of an entity depends upon its ability to generate cash** from operations. For example, profit which is tied up in a large amount of inventory may weaken the liquidity position of the company as all its cash is invested in inventory.
3. **Trade payables and banks are more interested in cash flow figures.** They want to know the repayment capacity of the entity.
4. The statement of cash flows is much **simpler to understand**, even for businessmen who do not have in-depth accounting expertise.
5. The statement of cash flows helps the user to evaluate the financial structure and the ability of the entity to adapt to changing circumstances. E.g. if an entity has a reasonable balance of cash and cash equivalents, it may be better placed to cope with impending financial liabilities.
6. Future projections: a statement of cash flows of, for example, 3 to 5 years can be used to project future cash flows. This, along with the other financial statements, will help the entity plan for the future.

It helps in **planning the future cash movements**, checking the actual movements against those planned, and taking corrective actions.

Example

After an analysis of the past 2 - 3 years' cash flows and the financial statements, TRB Ltd projected the cash collections from customers for the year 20X7 - X6 to be \$800m.

However, the actual collections turned out to be only \$600m. The finance manager and the sales manager analysed the variance together, and found that cash inflows from two of the major customers Chris and Joe had slowed down.

At Chris's factory there was a strike which had ended recently so cash flows would be back to normal soon.

Joe was setting up a new plant and had diverted a part of his working capital for investment in the new plant, causing cash shortage. It was decided that the sales manager should arrange a meeting with Joe's general manager to sort out the issues.

7. When used along with the other financial statements, the statement of cash flows helps the users **evaluate changes in the financial position of an entity, its financial structure and its ability to affect the amounts and timing of cash flows.**

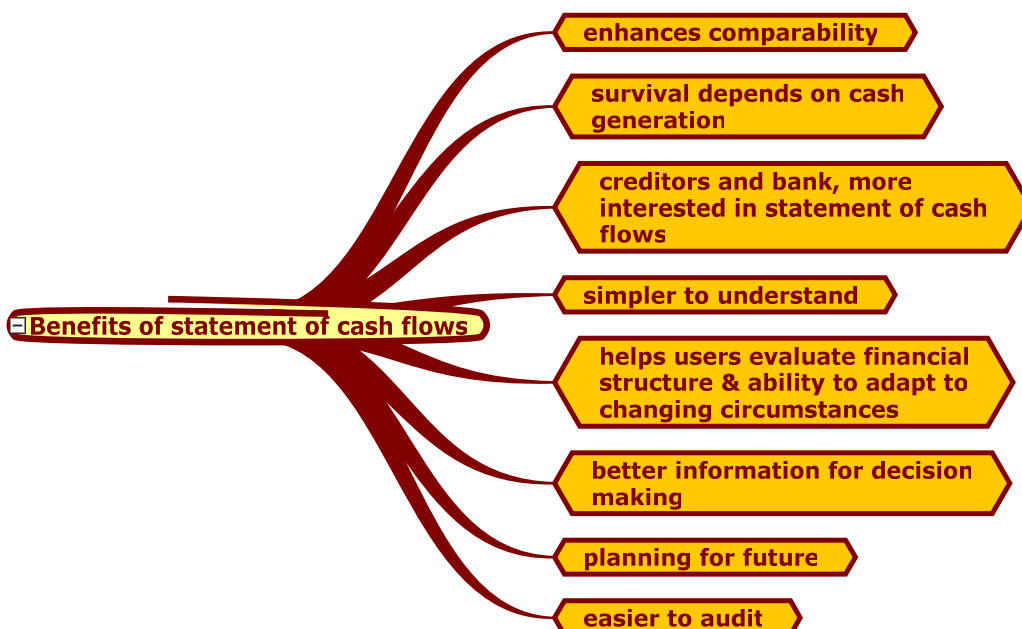
Example

If a loan liability has been reduced, it may or may not be an outflow of cash.

- If it is a loan repayment, the statement of cash flows will disclose this fact.
- If some other asset has been given up to reduce the loan, the notes to accounts will disclose this.

8. The statement of cash flows is easier to audit.

SUMMARY



3.2 The interpretation of the information in a statement of cash flows is done with the help of the following ratios:

1. Liquidity ratios (This topic has been dealt with in detail in Study Guide D1, Learning Outcome 1.)
2. Cash flow ratios

a) **The ratio of long-term borrowings to cash generated from operations** measures the ability of the company to meet its long-term obligations from its operating activities. It is calculated as:

$$\frac{\text{Long - term borrowings}}{\text{Cash generated from operations}}$$

Example

If the cash generated from operations is \$24,000 and the long-term borrowings are \$240,000, then the ratio of long-term borrowings to cash generated from operations is:

$$\frac{\$240,000}{\$24,000} = 10 \text{ years}$$



Important

Rule of thumb for analysis purposes: If the **number of years** is **lower** than the **number of years of the agreed repayment schedule**, then management **can invest the excess funds** (if any, after payment of tax and interest costs) in more profitable ventures.

If the **number of years** is **higher** than that **in the agreed repayment schedule**, management will have to **take out more loans** to repay the original loans and pay the interest costs.

Example

Rain Plc has a loan of \$60,000. Cash generated from operations is \$12,000.

This means that it will take $60,000/12,000 = 5$ years for the operating activities of the company to generate cash which will be sufficient to repay the loan.

If the agreed repayment schedule is 7 years, then the company will be able to generate some cash for investing activities (if any excess remains after paying tax and interest costs).

If the agreed repayment schedule is 3 years, then the company will have to take out a new loan in order to repay this loan.



Tip

This ratio **assumes** that cash generated from operations will **remain constant** throughout the loan period. This is **not likely to happen** and so, at best, this ratio can be used as a guide.

b) **Net cash from operating activities to capital expenditure** helps decide the extent to which the operating activities of a company can finance its capital expenditure. It is calculated as:

$$\frac{\text{Net cash from operating activities}}{\text{Capital expenditure}} \times 100$$

Example

If net cash from operating activities is \$33,450 and capital expenditure is \$95,000, then the ratio of net cash from operating activities to capital expenditure is:

$$\frac{\$33,450}{\$95,000} \times 100 = 35.21\%$$



Important

Rule of thumb for analysis purposes: The **higher** this ratio, the **less** the company will have to depend on outside borrowings to finance its capital expenditure.

Warning: If the company has recently acquired a lot of capital assets, then this ratio will not be very useful if the period required by the new investments to earn returns is high.

Example

In the above example, if \$30,000 of the capital expenditure is made in the last month of the year, then it is not possible to expect returns from it immediately. Hence net cash from operating activities of 35.21% is not realistic. A more relevant ratio can be calculated by reducing the capital expenditure by \$30,000.

The revised ratio will be:

$$\frac{\$33,450}{\$65,000} \times 100 = 51.46\%$$

This is a much better ratio than the earlier one.

Answers to Test Yourself

Answer 1

- For smooth running of day-to-day operations
- For ensuring liquidity
- For ensuring balance between liquidity and profitability

Answer 2

- Financing activities
- Not a cash flow item, although needs a separate disclosure (section 2e)
- Operating activities
- It is a non-cash item. Not included in the cash flow. In the indirect method, it is added back to arrive at cash flows from operating activities, since the starting net profit is after depreciation.
- Investing activities
- Either as a finance activity or as an operating activity. (The IAS allows flexibility to entities to decide how to classify interest and dividends, depending upon circumstances and the management's judgement).
- Operating activities, unless they can be specifically identified with financing and investing activities.

Answer 3

Cash flows from the operating activities for the year ended 31 March 20X8

	\$
Cash receipts from customers (W1)	5,000,000
Cash paid to suppliers and employees (W2)	(4,000,000)
Cash generated from operations	1,000,000
Interest paid	(200,000)
Income tax paid	(250,000)
Net cash from operating activities	550,000

Workings:**W1 Calculate the cash received from customers:**

Receivables account			
Dr	\$'000	Cr	\$'000
Balance brought forward	500	Cash received (balancing figure)	4,200
Credit sales	4,270	Balance carried forward	570
Total	4,770	Total	4,770

Total receipts from customers = Cash sales + collections from credit customers
 = 800 + 4,200
 = 5,000

W2 Calculate the cash paid to suppliers

Payables account			
Dr	\$'000	Cr	\$'000
Cash paid (balancing figure)	3,200	Balance brought forward	300
Balance carried forward	350	Credit purchases	3,250
Total	3,550	Total	3,550

Cash paid to suppliers and employers = Cash purchases + payments to credit suppliers
 + cash paid to employees
 = 200 + 3,200 + 600
 = 4,000

Answer 4**Cash flows from operating activities for the year ended 31 March 20X8**

	\$
Profit before taxation	640,000
Adjustments for:	
Add: Depreciation	90,000
Add: Development expenses written off	30,000
Less: Investment income	(20,000)
Add: Interest expense	200,000
	940,000
Decrease / (Increase) in trade and other receivables	(70,000)
Decrease / (Increase) in inventories	80,000
Increase / (Decrease) in trade payables	50,000
Cash generated from operations	1,000,000
Interest paid	(200,000)
Income tax paid	(250,000)
Net cash from operating activities	550,000

Self Examination Question

The following information has been extracted from the draft financial statements of Amazing Ltd

Amazing Ltd's statement of financial position as at 31 May

	20X9		20X8	
	\$'000	\$'000	\$'000	\$'000
Assets				
Non-current assets		3,910		2,295
Current assets				
Inventory	493		425	
Trade receivables	306		195	
Bank	-	799	145	765
Total assets		4,709		3,060
Equity and liabilities				
Capital and reserves				
Ordinary share capital	2,975		2,015	
Share premium	255		127	
Retained earnings	894	4,124	400	2,542
Non-current liabilities				
10% Loan note (redeemable 31/05/ 20X8)				85
Current liabilities				
Trade payables	383		310	
Taxation	153		123	
Bank overdraft	49	585	-	433
Total equity and liabilities		4,709		3,060

Additional Information:

- i) During the year the dividends paid were \$230,000.
- ii) Profit before tax had been arrived at after charging \$595,000 for depreciation on non-current assets.
- iii) A non-current asset was sold for \$153,000 which had a net book value of \$170,000.
- iv) The SOCI (income statement) for the year ended 31 May 20X9 shows the following:

	\$'000
Operating profit	886
Interest payable	(9)
Profit before taxation	877
Tax	(153)
Profit for the financial year	724

Required:

Prepare a statement of cash flows for Amazing Ltd for the year ended 31 May 20X9 in accordance with IAS 7 'Statement of cash flows', using the indirect method.

Answer to Self Examination Question
--

Answer**Amazing Ltd – Statement of cash flows for the year ended 31 May 20X9 (Indirect method)**

	\$'000	\$'000
Cash flows from operating activities		
Net profit before tax	877	
Adjustments for:		
Depreciation	595	
Loss on sale of tangible non-current assets	17	
Interest	9	
Operating profit before working capital changes	1,498	
Increase in inventory	(68)	
Increase in receivables	(111)	
Increase in payables	73	
Cash generated from operations	1,392	
Interest paid	(9)	
Tax paid W2	(123)	
Dividends paid	(230)	
Net cash from operating activities		1,030
Cash flow from investing activities		
Purchase of non-current assets W1	(2,380)	
Receipts from sales of tangible non-current assets	153	(2,227)
Cash flows from financing activities		
Proceeds from issue of share capital	1,088	
Repayment of long term borrowing	(85)	1,003
Net increase / (decrease) in cash and cash equivalents		(194)
Cash and cash equivalents at the beginning of period		145
Cash and cash equivalents at end of period		(49)

W 1**Non-current assets**

Dr	\$'000		Cr
	\$'000		\$'000
Balance b/f	2,295	Depreciation	595
New non-current assets (bal fig.)	2,380	Disposals	170
		Balance c/f	3910
	4,675		4,675

W2**Tax**

Dr	\$'000		Cr
	\$'000		\$'000
Tax paid (Balancing figure)	123	Balance b/f	123
Balance c/f	153	SOCI (income statement)	153
	276		276

Note: Dividends paid and interest paid may be shown in either operating activities or financing activities.



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