Jihočeská univerzita
v Českých Budějovicích
University of South Bohemia
in České Budějovice

FINANCIAL STATEMENTS
- Study Text

FINANCIAL STATEMENTS: STATEMENT OF CASH FLOW

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EVROPSKÁ UNIE
Evropské strukturální a investiční fondy
Operační program Výzkum, vývoj a vzdělávání

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MLÁDEŽE A TĚLOVÝCHOVY

1 DEFINITIONS

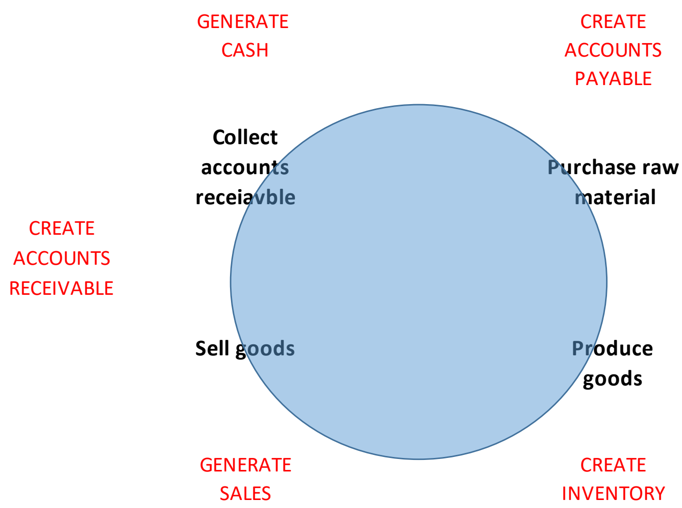
Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation.

Statement of Cash Flow

- cash flow: "cash" - money and "flow" - flow, sometimes used term net cash income

- the basic question of doing business: How much money is needed?

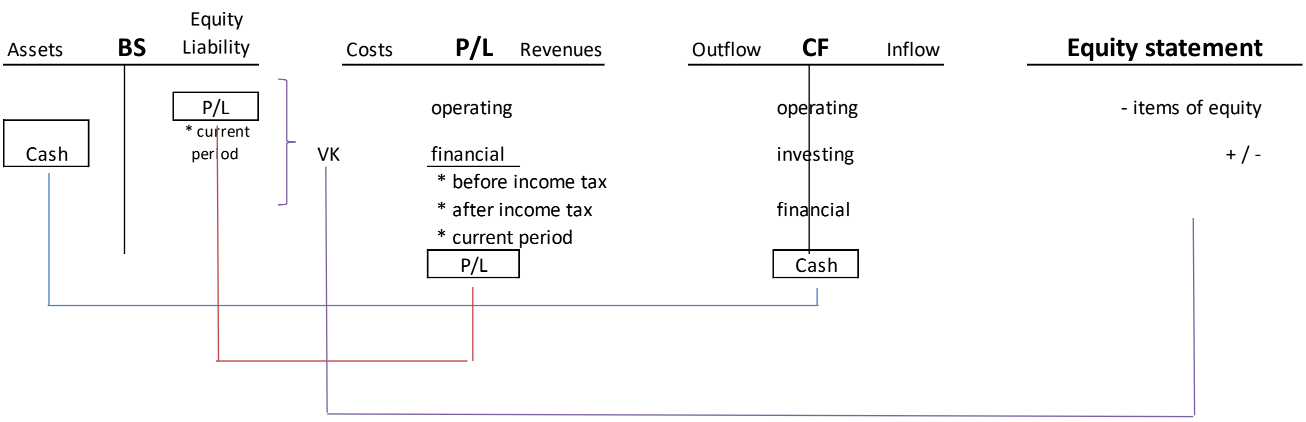
    - see the operating (business, property) cycle:



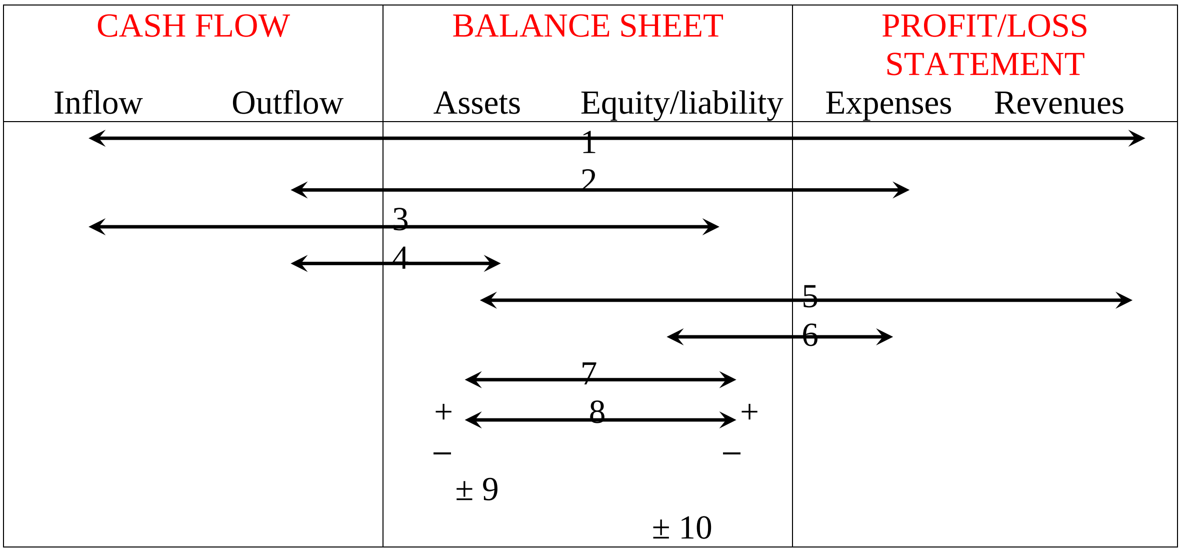
    - each ↑ assets → ↓ money

- reason for compilation: difference from load - yield - ie impact on VH

- link to balance sheet and profit/loss statement - see report link schema



Impact of accounting operations on other statements



<u>Accounting system (double-entry)</u>

- the so-called accrual principle

- four basic types of accounting operations with a different impact on cash flow:

1. Effective (influencing PP) and non-profitable
2. Profitable (affect profit) and do not affect the funds
3. Profitable and financially effective
4. Does not affect profit or cash

→ Transformation of costs (expense) and revenues into outflow (expenditures) and inflow.

<u>Tax records</u>

- monitors inflow/outflow → ie cash flow

Profit and cash

Whilst a business entity might be profitable this does not mean it will be able to survive. To achieve this a business entity needs cash to be able to pay its debts. If a business entity could not pay its debts it would become insolvent and could not continue to operate.

The main reason for this problem is that profit is not the same as cash flow. Profits (from the statement of profit or loss) are calculated using the accruals basis. Most goods and services are sold on credit so that, at the point of sale, revenue is recognised but no cash is received. The same can be said of purchases made on credit. There are also a number of expenses that are recognised that have no cash impact - depreciation is a good example of this. Therefore, it is possible for a business entity to be profitable but have insufficient cash available to pay its suppliers.

For this reason it is important that users of the financial statements can assess the cash position of a business entity at the end of the year but also how cash has been generated and used by the business entity during the accounting period. In the case of limited liability entities, IAS 7 requires that (with very few exceptions) a statement of cash flows is included as part of the annual financial statements that corporate business entities make available to shareholders and other users of that information.

Cash flow concepts: liquidity, liquidity, solvency, insolvency (primary, secondary), flow and status item. Cash flow we need for internal or external use.

Users of an entity's financial statements are interested in how the entity generates and uses cash and cash equivalents. This is the case regardless of the nature of the entity's activities and irrespective of whether cash can be viewed as the product of the entity, as may be the case with a financial institution. Entities need cash for essentially the same reasons however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors. Accordingly, this Standard requires all entities to present a statement of cash flow.

A statement of cash flow, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the entity to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different entities. It also enhances the comparability of the reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for the same transactions and events.

Cash flow management

As mentioned above, cash flow is vital to the survival of a business entity both in the long and the short term. To reflect this, one of the key measures of the health of a business is solvency or liquidity. These concepts will be discussed at greater length in the interpretations chapter.

In summary, management have various liquid assets at their disposal that they can use to settle their debts in the short term. These include inventory, receivables and cash (i.e. current assets). They are used to pay off overdrafts, trade payables, loan interest and tax balances (i.e. current liabilities).

Management should maintain sufficient current assets to be able to pay their current liabilities as they fall due. If they do not, they will default on their payments, lose supplier goodwill or suffer fines and sanctions. In the worst case scenario a supplier, lender or tax authority may even have a business entity declared insolvent in an attempt to recover amounts due to them.

To ensure an effective balance, management must consider inventory production and storage cycles and have an effective system of credit control to ensure cash is received as soon as possible. On the flip side it must also manage the level of debt t is exposed to.

The benefits of a statement of cash flow

A statement of cash flows is needed as a consequence of the differences between profits and cash, as explained earlier. It helps to assess:

- liquidity and solvency – an adequate cash position is essential in the short term both to ensure the survival of the business entity and to enable debts and dividends to be paid.
- financial adaptability – will the business entity be able to take effective action to alter its cash flows in response to any unexpected events?
- future cash flows – an adequate cash position in the longer term is essential to enable asset replacement, repayment of debt and fund further expansion.

The bottom line is: cash flow means survival. A business entity may be profitable but, if it does not have an adequate cash position, it may not be able to pay its debts, purchase goods for resale, pay its employees etc.

The statement of cash flows also highlights how cash is being generated, i.e. either from operating, financing or investing activities. A business entity must be self-sufficient in the long term; in other words, it must generate operating cash inflows or it will be reliant on the sale of assets or further finance to keep it afloat.

Cash flows are also objective; they are matters of fact, whereas the calculation of profit is subjective and easy to manipulate.

2 TERMS

Basic terms include:

Cash comprises cash on hand and demand deposits.

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

Cash flows are inflows and outflows of cash and cash equivalents.

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

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

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

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date.

Bank borrowings are generally considered to be financing activities. However, in some countries, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. In these circumstances, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.

Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

3 PRESENTATION OF A STATEMENT OF CASH FLOW

The statement of cash flow shall report cash flows during the period classified by operating, investing and financing activities.

An entity presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the entity and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

A single transaction may include cash flows that are classified differently. For example, when the cash repayment of a loan includes both interest and capital, the interest element may be classified as an operating activity and the capital element is classified as a financing activity.

Format of a statement of cash flows

IAS 7 Statement of Cash Flows requires business entities to prepare a statement of cash flows as part of their annual financial statements. The cash flows must be presented using standard headings. Note: There are two methods of reconciling cash from operating activities, which will be discussed later in this chapter.

You should ensure that you understand the items that are included within each of the three sections of the statement of cash flows, together with the reconciliation of the net increase or decrease in cash and equivalents for the year.

Statement of cash flows for the period ended 31 December XXX

Cash flows from operating activities

Cash generated from operations

Interest paid

Income taxes paid

Net cash flow from operating activities

Cash flows from investing activities

Purchase of property, plant and equipment

Proceeds of sale of equipment

Interest received

Dividends received

Net cash flow from investing activities

Cash flows from financing activities

Proceeds of issue of shares

Receipt of new loans

Repayment of loans

Dividends paid

Net cash flow from financing activities

Net increase (decrease) in cash and cash equivalents

Cash and cash equivalents at the beginning of the period

Cash and cash equivalents at the end of the period

Key points

- Operating activities are the principal revenue-producing activities of the business. This section of the statement begins with profit before tax and is adjusted for various items which have been taken into account in arriving at profit before tax but which do not involve the movement of cash to arrive at 'Cash generated from operations'. This, in turn, is further adjusted to deduct interest paid and tax paid in the year to arrive at 'Net cash flow from operations'. Note that 'Net cash flow from operating activities can be calculated using either the direct or indirect method, and both will be explained and illustrated as the chapter progresses.

- Investing activities are cash spent on non-current assets, proceeds of sale of non-current assets and income from investments.
- Financing activities include the proceeds of issue of shares and long-term borrowings made or repaid.
- Net increase or decrease in cash and cash equivalents is the overall increase (or decrease) in cash and cash equivalents during the year. This can be calculated by comparing the level of cash and cash equivalents included in the statement of financial position at the start and at the end of the accounting period.
- Cash is defined as cash in hand and bank current account balances, including overdrafts.
- Cash equivalents are defined as current asset investments (short-term, highly liquid investments, e.g. a 30 day bond).

3.1 Operating activities

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. 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 that is included in recognized profit or loss. The cash flows relating to such transactions are cash flows from investing activities.

An entity may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial institutions are usually classified as operating activities since they relate to the main revenue-producing activity of that entity.

3.2 Investing activities

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;

(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

(d) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to other parties (other than advances and loans made by a financial institution);

(f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

3.3 Financing activities

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity. Examples of cash flows arising from financing activities are:

(a) cash proceeds from issuing shares or other equity instruments;

(b) cash payments to owners to acquire or redeem the entity's shares;

(c) cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings;

(d) cash repayments of amounts borrowed; and

(e) cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

4 METHODOLOGY

<u>Reporting cash flows from operating activities</u>

An entity shall report cash flows from operating activities using either:

(a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) 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.

Entities are encouraged to report cash flows from operating activities using the direct method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method. Under the **direct method**, information about major classes of gross cash receipts and gross cash payments may be obtained either:

(a) from the accounting records of the entity; or

(b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the statement of comprehensive income for:

(i) changes during the period in inventories and operating receivables and payables;

(ii) other non-cash items; and

(iii) other items for which the cash effects are investing or financing cash flows.

Under the **indirect method**, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, undistributed profits of associates, and non-controlling interests; and

(c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the revenues and expenses disclosed in the statement of comprehensive income and the changes during the period in inventories and operating receivables and payables.

The indirect method of presenting cash flows from operating activities relies upon information that is disclosed in the financial statements, or can be calculated from information disclosed in the financial statements. The starting point is normally profit before tax, which is then adjusted to remove any non-cash items or accruals-based figures included in the statement of profit or loss. The following are examples of adjustments that are normally required when preparing cash flows from operating activities using the indirect method:

- Depreciation – added back to profit before tax because it is a non-cash expense

- Loss on disposal of non-current assets - the loss a non-cash expense and is added back to profit before tax: the cash proceeds on disposal will be classified as an investing activity cash inflow. Note that a gain on disposal is deducted from profit before tax

- Interest payable expense – added back to profit before tax because it is not part of cash generated from operations (the cash payment is deducted elsewhere in the statement of cash flows – refer to the proforma statement)

- Increase/decrease in inventory – inventory represents purchases made in one accounting period, but which will be charged against profit in another accounting period. An increase in inventory is deducted from profit before tax as it represents a cash outflow to pay for the additional inventory. A decrease in inventory is added to profit before tax as it represents a cash inflow from disposing of inventory

- Increase/decrease in trade receivables – trade receivables represent revenue recognised in profit or loss in one accounting period, whilst the cash will be received in the following accounting period. An decrease in receivables is added to profit before tax as it represents a cash inflow as more cash has been collected from receivables. An increase in trade receivables is therefore deducted from profit before tax

- Increase/decrease in trade payables – trade payables represent purchases made in one accounting period which will be paid for in the following accounting period. An increase in trade payables means that the business entity has had the use or benefit of goods and services provided, but not yet paid for them. As such, it preserves cash resources within the business and is added back to profit before tax. A decrease in trade payables indicates that more payables have been paid off, and will therefore be deducted from profit before tax as a cash outflow.

Items		**Impact on CF**
Assets +		–
Assets –		+
	Equity/liability +	+
	Equity/liability –	–
Revenue YES	Inflow NO	–
Expense YES	Outflow NO	+
Inflow YES	Revenue NO	+
Outflow YES	Expense NO	–

<u>**Reporting cash flows from investing and financing activities**</u>

An entity shall report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in paragraphs 22 and 24 are reported on a net basis.

Investing activities cash inflows may include:

- interest received
- dividends received
- proceeds of sale of non-current assets.

Cash outflows may include:

- purchase of property, plant and equipment.

Cash inflows from financing activities may include:

- proceeds of the issue of shares
- proceeds of receipt of loans/debentures.

Cash outflows may include:

- repayment of loans/debentures
- dividends paid
- interest paid.

Reporting cash flows on a net basis

Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity; and

(b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

Examples of cash receipts and payments are:

(a) the acceptance and repayment of demand deposits of a bank;

(b) funds held for customers by an investment entity; and

(c) rents collected on behalf of, and paid over to, the owners of properties.

Examples of cash receipts and payments referred are advances made for, and the repayment of:

(a) principal amounts relating to credit card customers;

(b) the purchase and sale of investments; and

(c) other short-term borrowings, for example, those which have a maturity period of three months or less.

Cash flows arising from each of the following activities of a financial institution may be reported on a net basis:

(a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;

(b) the placement of deposits with and withdrawal of deposits from other financial institutions; and

(c) cash advances and loans made to customers and the repayment of those advances and loans.

Resources for cash flow calculation:

→ accounting:

- balance sheet accounts
- profit accounts
- synthetic accounts
- analytical accounts
- statements from bank accounts
- cash book
- book of books (accounts, records) of cash equivalents

Is better cash flow than profit/loss?

Yes → CF:

• is not affected by the depreciation method

• Not distorted by time difference

• the implementation principle is not applied here (transfer of ownership increases receivables, not PP)

• does not affect the precautionary principle (creation of OP, reserves)

Sample of statement

Minimum compulsory information under Regulation 500/2002 Coll.

CASH FLOW STATEMENT

as at December 31st, 2017

(in thousands of Czech Crowns)

Comercial name or other name of an accounting unit

Registered office or adress of an accounting unit

P.			**Balance of cash on hand and financial equivalents as at the beginning of reporting period**	0
			Cash flows from running activities	
Z.			Accounting profit/loss from running activities before taxation	0
A.	1		Adjustments by non-cash operations	0
A.	1	1	Depreciation of fixed assets and amortization of adjustments to acquired assets	0
A.	1	2	Change in balance of adjustments, reserves	0
A.	1	3	Profit from sales of fixed assets	0
A.	1	4	Revenue from shares in profit	0
A.	1	5	Accounted for interest expense, exclusive of interest capitalization and accounted for credit interest	0
A.	1	6	Possible adjustments by other non-cash operations	0
A.	*		**Net cash flow from running activities before taxation, changes in working capital**	0
A.	2		Change in non-cash items of working capital	0
A.	2	1	Change in balance of receivables from running activities, temporary assets accounts	0
A.	2	2	Change in balance of short-term payables from running activities, temporary liability accounts	0
A.	2	3	Change in balance of inventory	0
A.	2	4	Change in balance of current liquid assets not included in cash or equivalents	0
A.	**		**Net cash flow from running activities before taxation**	0
A.	3		Paid interest with the exception of interest included in fixed assets pricing	0
A.	4		Interests received	0
A.	5		Income tax for running activities and additional tax assessments for previous periods	0
A.	6		Income and expense on unusual and/or extraordinary items, including income tax	0
A.	***		***Net cas flow from running activities***	0
			Cash flows from investing activities	
B.	1		Expense on fixed assets acquisition	0
B.	2		Income from fixed assets sales	0
B.	3		Loans to related parties	0
B.	***		***Net cash flow from investing activities***	0
			Cash flows from financing activities	
C.	1		Change in balance of long-term or short-term payables	0
C.	2		Impact of changes in equity on cash on hand and financial equivalents	0
C.	2	1	Increase in cash on hand as a result of increased registered capital, share premium etc.	0
C.	2	2	Payment of share in equity to partners	0
C.	2	3	Other contributions of cash by partners and shareholders	0
C.	2	4	Loss coverage by partners	0
C.	2	5	Direct debit fund payments	0
C.	2	6	Paid shares in profit, including taxes paid	0
C.	***		***Net cash flow from financing activities***	0
F.			***Net increase/decrease in cash on hand***	0
R.			**Balance of cash on hand and financial equivalents as at the end of reporting period**	0