

## MEASURING AND REPORTING CASH FLOWS

### The Statement of Cash Flows – prepared 2nd

- It reports the inflows and outflows of cash and cash equivalents under the headings 'operating', 'investing' and 'financing'
- It reconciles the opening and closing balance of cash and cash equivalent accounts
- Note: Cash Flow Statement uses cash-based transactions NOT accrual-based transactions
- The Importance of Cash and Cash Flows
  - Cash is important because people and organisations will not normally accept any other way of settling their claims against the business apart from cash
  - ∴ cash is the main business asset
  - Businesses fail as a result of their inability to find cash to pay claimants/responsibilities
  - This statement is required to be produced because the other two statements don't concentrate sufficiently on liquidity (cash flow)
- Cash and Cash Equivalents
  - Cash – cash on hand and demand deposits
  - Cash equivalents – short term highly liquid investments that can readily be converted to a fixed amount of cash
    - E.g. short-term money market deposits, petty cash fund (2 year fixed deposit is NOT an example)
- Cash vs. Accrual Transaction Recognition
  - Cash-based transaction: recognise revenue when cash is received and recognise expense when cash is paid
    - This system can distort the entity's measure of performance during a particular period
  - Accrual-based transaction: recognise revenue when it is earned and recognise expense when it is incurred
    - Reflects the economic reality of financial transactions
- Statement of Cash Flows
  - Analysis of the business's cash movements for the period
  - Is a summary of the cash receipts and payments over the period
  - All payments of similar types are added together to give just one figure which is presented in the statement
  - Net total of the statement is the net increase or decrease of the cash of the business over the period
  - Layout – 3 Components
    - Cash Flows from Operating Activities
      - Net inflow from operations
      - Principle revenue producing activities of the entity and other activities that are not investing or financing
      - Flows that relate to items recognised in the income statement
      - Only cash received and cash paid is shown (NOT revenue and expenses)
      - Cash receipts from
        - Customers from cash sales or receivables

- Cash collected from debtors
- Interest or dividends received
  - only part of operating activities if the dividends are received frequently, otherwise it's not part of this category
  - If you put it here, must state the businesses purpose so the marker knows receiving them is part of regular operations
- Cash payments for
  - Inventory or services from suppliers
  - Wages and expenses
  - Taxes to governments (ALWAYS here)
  - Interest to lenders (only part of operating activities if the dividends are received frequently, otherwise it's not part of this category)
- Cash Flows from Investing Activities
  - Concerned with cash payments made to acquire additional non-current assets and cash receipts from the disposal of such assets
  - Flows that relate to changes in non-current assets in the balance sheet
  - Usually negative since most types of fixed assets wear out and because companies tend to seek to expand their asset base
    - For negative figures, use brackets
  - E.g. plant and machinery, investments
  - Cash receipts from
    - Proceeds from sales of property, plant and equipment (PP&E) or investments
    - Loan repayments from others
  - Cash payments for
    - Purchase/acquisition of PP&E or business
    - Shares/debentures for investment purposes
- Cash Flows from Financing Activities
  - Deals with financing the business, excluding short-term credit
  - Flows that change the size or composition of the financial structure
  - E.g. debt and equity sources, share issues, repayment of debt
  - Cash receipts from
    - Proceeds of share issue
    - Cash from borrowing
    - Issue of ordinary shares/capital
  - Cash payments for
    - Repayment of loans/borrowings
    - Share buybacks
    - Dividends paid (ALWAYS here)
- Net increase in cash and cash equivalents held

- Total is the net ↑ or ↓ in cash over the period covered by the statement
- We should expect/hope this is positive
- A comparison of the statement over time enables us to identify trends and make comparisons with other companies
- Final figure is normally higher than the profit recorded since the cash flows don't include non-cash expenses like depreciation and also doesn't account for interest and tax payments

Business XYZ Statement of Cash Flows For the year/month/period ended .....		
	Sub-total	Total
<b>Cash Flows from Operating Activities</b>		
Cash received from customers	1200	
Cash payments to suppliers/employees	(800)	
Interest paid/received	(170)	
Tax paid	(160)	
<i>Net Cash Provided from Operating Activities</i>		70
<b>Cash Flows from Investing Activities</b>		
Proceeds from sale of non-current assets	605	
Paid for purchases of non-current assets	(805)	
<i>Net Cash Used in Investing Activities</i>		(200)
<b>Cash Flows from Financing Activities</b>		
Proceeds from share issue	2000	
Bank Loan	(1600)	
Paid for dividends	(270)	
<i>Net Cash Provided by Financing Activities</i>		130
<b>Net Increase in Cash</b>		0
<b>Cash Balance at the Beginning of the Period</b>		20
<b>Cash Balance at the End of the Period</b>		20

What does the Statement of Cash Flows tell us?

- Tells us how the business has generated cash during the period and where that cash has gone
- It tracks the sources and uses of cash over time, which is indicative of trends and useful for predicting future opportunities and patterns of cash flow
- Shows financing trends, provides insight to working capital management and identifies non-operational cash flows
- It is a good indicator of debt management practices
- Non-Cash Transactions
  - These transactions don't directly involve cash
  - Most relate to the operating activity section and are linked directly to the difference between cash-based transactions and accrual-based transactions
    - Income earned in this period differs from the cash received in this period

- Expenses incurred in this period differ from the cash paid in this period
  - E.g. depreciation, doubtful debts, revaluations, accruals (receivables, prepayments, payables, gains or losses on the disposal of non-current assets etc.)
  - Investing and financing activities here relate to changes in the non-current assets and liabilities and OE that don't involve cash
    - Acquisition of non-cash assets by an exchange with other non-cash assets by issuing debt securities or shares
    - Reduction in non-current debt by settlement with non-cash assets by exchange with another debt instrument or by issuing shares
    - Internal changes or transfers within the equity section of the statement
- Benefits of the Cash Flow Statement
  - Explains what caused the movement in cash balance and other items impacted by the cash flows
  - Helps measure cash sufficiency and business solvency
  - Helps users evaluate
    - Investing and financing transaction during the period (not just the operating activities)
    - The entity's ability to generate future cash flows
    - Differences between net profit and net cash provided/used from operating activities
- Preparation of the Statement of Cash Flows
  - 2 methods of calculating and reporting the cash flows from the operating section (no difference in the investing and financing section)
    - Direct Method – Cash inflows and outflows from operating are calculated directly and individually listed to derive net cash flow from operating activities
    - Indirect Method – net cash inflow and outflows from operating total is calculated indirectly by adjusting net profit to derive the net cash flow from operating activities
      - Doesn't show directive individual inflows and outflows
      - Eliminates non-cash and accrual items from net profit
  - Reconstruction of the statement of comprehensive income is the most often method used (indirect method) and for this reconstruction, 3 alternative approaches can be used