ACCG224 | FINANCIAL ACCOUNTING & REPORTING

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Statement of Cash Flows – Overview and Direct Method

Purpose of the statement of cash flows

1. **The statement of cash flows can assist investors, creditors and other users of financial statements to evaluate:**
    1. The entity's ability to generate cash and cash equivalents
    2. The entity's ability to affect the amount, timing and certainty of generating future cash flows
    3. The entity's need to utilise cash and cash equivalents

2. **The classification of cash flows as arising from:**
    1. Operating activities
    2. Investment activities
    3. Finance activities

   is useful in analysing the movement in cash and cash equivalents during the period

3. **When used in conjunction with other financial statements, information about cash flows assists users of financial statements to:**
    1. Predict future cash flows
    2. Evaluate an entity's financial structure (including liquidity) and its ability to meet its obligations and to pay dividends

4. **When used in conjunction with other financial statements, information about cash flows assist users of financial statements to:**
    1. Understand the reasons for the difference between profit or loss for a period and the net cash flow from operating activities
    2. Compare the operating performance of different entities

General Format of the Cash Flow Statement

1. **Appendices to AASB 107 provide examples of acceptable formats for the CFS**
    - Refer to figure 17.18 in the textbook
2. **AASB 107 requires all cash flows to be reported on a gross basis**
    - This is important
3. **A net basis is only allowed in the following circumstances:**
    - Cash receipts and payment on behalf of customers where this reflects the activities of the customer
    - Cash receipts and payment where there is quick turnover, large amounts and short maturities

Concept of Cash

1. **Cash**
    - Cash on hand and demand deposits
    - Includes bank overdrafts
2. **Cash equivalents**
    - Short-term, highly liquid investments readily convertible into known amounts of cash, and which are subject to an insignificant risk of changes in value
    - Held to meet cash commitments and have a short maturity
    - **Example: short-term interest bearing** deposits

Classifying cash flows

1. **Regardless of format used AASB 107 requires that all cash flows be classified into the following categories**
    1. Operating activities
    2. Investing activities
    3. Financing activities

2. **Interest and dividends**
    - AASB 107 allows some options how interest and dividends can be classified
    - Requires them to be separately disclosed and classified consistently across periods

3. **Overview of possible options**

	Operating	Investing	Financing
Interest/dividends received	X	**X***	-
Interest paid	**X***	-	X
Dividends paid	X	-	**X***
Income tax paid	**X**	-	-

Classifying cash flows: operating activities

1. **The principal revenue-producing activities of an entity**

2. **Examples include:**
    - Cash inflows from:
        - Sale of goods/rendering of serves
        - Royalties, fees and commissions
    - Cash outflows to:
        - Suppliers and employees for goods and services
        - Government for income and other taxes
        - Lenders for interest (may be financing)

3. **Cash flows from operating activities may be presented using one of two methods**
    1. Direct method
        i. Discloses classes of gross cash receipts and payments

- shows cash flows, therefore: direct method

2. Indirect method
   i. Shows differences between profit and net cash flow from operating activities
      - The accrual-basis profit is adjusted to a cash-basis operating profit by making adjustments (therefore: indirect method) for the effects of:
        (1) non-cash items
        (2) investing or financing (=non-operating) items
        (3) movements in operating assets and liabilities

4. The direct method is encouraged

- If the direct method is chosen for the presentation of the operating activities the entity has to show a reconciliation in the notes from profit to net cash flow from operating activities which is very similar to the indirect method

Classifying cash flows: investing activities

1. The acquisition/disposal of non-current assets and other investments

2. Examples include:

1. Cash inflows from:
   i. Sale of non-current assets (PPE)
   ii. Sale of financial investments (shares, debentures)
   iii. Repayment of loans advanced to other parties
   iv. Interest/dividends received (may be operating)
2. Cash outflows for:
   i. Purchase of non-current assets (PPE)
   ii. Purchase of financial investments (shares & debentures)
   iii. Lending money to other parties

Classifying cash flows: financing activities

1. Activities that result in size and composition changes in equity capital and borrowings

2. Examples include:

1. Cash inflows from:
   i. Issuing shares and other equity instruments
   ii. Issuing debentures
   iii. Borrowing (loans, mortgages)
2. Cash outflows for:
   i. Buying back shares
   ii. Repaying debentures
   iii. Repaying borrowings
   iv. Paying dividends (may be operating)

Preparing a Cash Flow Statement: Overview

1. **Unlike the financial statements the CFS is not prepared from the general ledger trial balance**

2. **In principle, there are two main approaches:**
    1. Analysis of cash and other records
    2. Analysis of financial statements
        i. Reconstruction of cash flows by analysing comparative financial statements

3. **As it is the most common approach in practice, we will use the second approach**
    - Using comparative statements of financial position with supplementary information from the statement of comprehensive income and specific general ledger transactions

4. **Under this approach, cash flows can be reconstructed in a number of ways. Common methods include:**
    1. Formula method
    2. Reconstruction (T-ACCOUNT) method (used on these slides)
    3. Worksheet method

Preparing a CFS: Reconstruction of cash flows

1. **When using the direct method** for operating activities and for investing and financing activities always, we need to determine cash flows

2. **If we decide to reconstruct cash flows by analysing financial statements** many cash flows can easily be reconstructed by using items from the income statement or by determining the movements in the statement of financial position during the year

3. **The following cash flows can be more complicated:**
    1. Receipt from customers
    2. Payments to suppliers, employees and others
    3. Income tax paid
    4. Dividends paid

Calculating receipts from customers

1. **Sales revenue reflects sales** made by the entity during the year irrespective of whether the customer have paid for the sale
2. **Hence cash received in the current year includes sales made in the prior year** that were collected only in the current year and excludes sales made in the current year where the cash will be received in a future year
    - Therefore, the cash flows are determined by reference to the movement in the accounts receivable balance in the Statement of Financial Position
3. **Other factors affecting the accounts receivable account include:**
    - Discounts given to customers
    - Bad debts written off during the period

Calculating payments to suppliers

1. **Reflects payments made during the year for:**
    1. Inventory purchases
    2. All other supplies and services purchased
2. **Includes:**
    1. Payments for purchases made in prior years that are paid in the current year
    2. Prepayments made in the current year that will be expensed in future years
3. **Excludes**
    1. Purchases made in the current year where cash will be paid in a future year
    2. Expenses recognised in the current year that were prepaid in prior years
4. **Payments for inventory**
    1. Cash flows are determined by reference to the movements in inventory and in accounts payable
    2. Need to consider the impact of discounts given by suppliers when calculating the cash movements in accounts payable
5. **Payments for all other supplies and services**
    1. Cash flows are determined by identifying the expenses charged in the income statement and adjusting for the effect of movements in prepayments (deferrals) and other payables (accruals) during the year
    2. If the movement in statement of financial position is:
        i. DR - add to expenses
        ii. CR - deduct from expenses

Calculating income tax paid

- **The determination of tax paid** can be complicated by movements in deferred tax accounts (DTA/DTL)
- To determine the amount of tax paid it is often simplest to analyse the current tax liability account, including income tax expense and relevant movements in deferred tax assets and liabilities

Calculating dividends paid

- **To determine the amount of dividends:**
    - it is necessary to analyse the dividends payable account
- **Where details of dividends paid/declared during the year are not provided:**
    - They can be determined by reconstructing the Retained Earnings account.