

FINANCIAL STATEMENT ANALYSIS

Lecture 9

THE STATEMENT OF CASH FLOWS /CASH FLOW STATEMENT

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Statements of cash flows are a useful addition to the financial statements of a company because accounting profit is not the only indicator of performance. Statements of cash flows concentrate on the sources and uses of cash and are a useful indicator of a company's liquidity and solvency.

The *Statement of Cash Flows* reports the cash receipts, cash payments, and net change in cash resulting from the *operating, investing, and financing activities* of an enterprise during a period.

The *Statement of Cash Flows* is prepared in a format that reconciles the beginning and ending cash balances.

Note that beginning and ending balances for cash are found on the Balance Sheet. Thus, the cash flow statement is really a report which shows all of the debits and credits to cash during an accounting cycle in a particular format.

The *Statement of Cash Flows* is designed to answer the following questions:

- Where did cash come from during the period (i.e., source of debits to cash)?
- Where did cash go during the period (i.e., source of credits to cash)?
- What was the change in cash balance during the period?

“Cash Flows” reported on the *Statement of Cash Flows* are cash and *cash equivalents*.

Classifications of cash flows

Cash flows fall into three categories:

Operating activities

This is the key part of the statement of cash flows because it shows whether, and to what extent, companies can generate cash from their operations. It is these operating cash flows which must, in the end pay for all cash outflows relating to other activities, i.e. paying loan interest, dividends etc.

Most of the components of cash flows from operating activities will be those items which determine the net profit or loss of the enterprise, i.e. they relate to the main revenue-producing activities of the enterprise. The international accounting standard 7 (IAS 7) gives the following as examples of cash flows from operating activities.

- (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

Certain items may be included in the net profit or loss for the period which do *not* relate to operational cash flows, for example the profit or loss on the sale of a piece of plant will be included in net profit or loss, but the cash flows will be classed as financing.

Investing activities

The cash flows classified under this heading show the extent of new investment in assets which will generate future profit and cash flows. The standard gives the following examples of cash flows arising from investing activities.

- (a) Cash payments to acquire property, plant and equipment, intangibles and other non-current assets, including 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 non-current assets
- (c) Cash payments to acquire shares or debentures of other enterprises
- (d) Cash receipts from sales of shares or debentures of other enterprises
- (e) Cash advances and loans made to other parties
- (f) Cash receipts from the repayment of advances and loans made to other parties

Financing activities

This section of the statement of cash flows shows the share of cash which the enterprise's capital providers have claimed during the period. This is an indicator of likely future interest and dividend payments. The standard gives the following examples of cash flows which might arise under these headings.

- (a) Cash proceeds from issuing shares
- (b) Cash payments to owners to acquire or redeem the enterprise'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

Reporting cash flows from operating activities

The standard offers a choice of method for this part of the statement of cash flows.

- (a) **Direct method:** disclose major classes of gross cash receipts and gross cash payments
- (b) **Indirect method:** net 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

The direct method discloses information, not available elsewhere in the financial statements, which could be of use in estimating future cash flows. However, the indirect method is simpler, more widely used.

NB

Note that the following items are treated in a way that might seem confusing, but the treatment is logical if you **think in terms of cash**.

- (a) **Increase in inventory** is treated as **negative** (in brackets). This is because it represents a cash **outflow**; cash is being spent on inventory.
- (b) An **increase in receivables** would be treated as **negative** for the same reasons; more receivables means less cash.
- (c) By contrast an **increase in payables is positive** because cash is being retained and not used to settle accounts payable.

Format of the Cash Flow Statement

Under GAAP, there are two acceptable formats for the cash flow statement. They are the *Direct Method* and the *Indirect Method*. 95% of the time businesses use the indirect method because it is easier to prepare.

Direct method

While preparing the cash flow statement as per direct method, actual cash receipts from operating revenues and actual cash payments for operating activities are arranged and presented in the cash flow statement. The difference between cash receipts and cash payments is the net cash flow from operating activities under the direct method. In other words, it is an income statement (profit & loss a/c) prepared on cash basis under the direct method.

While preparing the cash flow statement as per direct method, items like depreciation, amortisation of intangible assets, preliminary expenses, debenture discount etc are ignored from cash flow statement since the direct method includes only cash transactions and non-cash transactions are omitted.

Likewise, no adjustment is made for loss/gain on the sale of fixed assets and investments while preparing the cash flow statement as per the direct method.

The activities of Acquisition and Disposal of Long Term Assets and other Investments not included in cash equivalents are Investing activities. 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.

XYZ Company
Statement of Cash Flows
For The Year Ended December 31, 202X

Cash flow from operating activities

Cash Receipts from Customers	xxx
Cash Paid to suppliers and employees	<u>(xxx)</u>
Cash generated from Operations	xxx
Income Tax Paid	<u>(xxx)</u>
Cash Flow before Extra-ordinary Items	xxx
Extra-ordinary items	<u>xxx</u>
Net Cash from Operating Activities (Direct Method)	<u>xxx</u>

Cash flows from investing activities

Add) Proceeds from Sale of Fixed Assets	xxx
(Add) Interest received	xxx
(Add) Dividend received	xxx
Net Cash Flow from Investing Activities	xxx

Indirect method

While preparing the cash flow statement as per the indirect method, the net profit/loss for the period is used as the base and then adjustments are made for items that affected the income statement but did not affect the cash

While preparing the cash flow statement as per the indirect method, non-cash and non-operating charges in the income statement are added back to the net profits while non-cash & non-operating credits are deducted to calculate the operating profit before working capital changes. The indirect method of preparing of cash flow statement is a partial conversion of accrual basis profit to cash basis profit. Further, necessary adjustments are made for increase/decrease in current assets and current liabilities to obtain net cash flows from operating activities as per the indirect method.

XYZ Company
Statement of Cash Flows
For The Year Ended December 31, 202X

Cash flows from operating activities

Net income		xx
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	x	
(Profit)Losses on disposal of fixed assets	<u>x</u>	
Operating cash flows before movement in working capital		xx
Decrease (increase) in accounts receivable	X	
Decrease (increase) in inventories	X	
Decrease (increase) in prepaid expenses	X	
Increase (decrease) in accounts payable	X	

Increase (decrease) in payroll-related liabilities	X	
Increase (decrease) in other non-debt short-term liabilities	<u>X</u>	<u>XX</u>
Net cash provided by (used by) operating activities		XX

Cash flows from investing activities

Cash inflows

Sale of equipment	X
Sale of investments	X
Dividends from joint ventures and associates	x
Interest received	x

Cash outflows

Purchase of fixed assets	(X)
Purchase of investments	<u>(X)</u>

Net cash provided by (used by) investing activities **XX**

Cash flows from financing activities

Cash inflows

Proceeds from long term loans	X
Proceeds from short term loans	X
Sale of common stock	X

Cash outflows

Repayments of long term loans	(X)
Repayments of short term loans	(X)
Payment of dividends	<u>(X)</u>

Net cash provided by (used by) financing activities **XX**

Net increase in cash **XX**

Cash at beginning of the period **XX**

Cash at the end of the period **XX**

Non-cash investing and financing activities

Purchasing equipment with long term debt **XX**

Note that whichever method is used that the same cash is generated from operating activities as can be observed from the hypothetical examples below:

Direct method

Operating activities \$

Cash received from customers	800,000
Cash paid to suppliers	(400,000)
Cash paid to staff	(126,000)
Other operating payments	(100,000)
Cash generated from operations	174,000
Interest paid	(12,000)
Taxation paid	<u>(13,000)</u>
Net cash from operating activities	<u>149,000</u>

Indirect method

Operating activities	\$
Profit before tax	82,000
Investment income	(12,000)
Finance cost	10,000
Depreciation	50,000
Amortization	40,000
Increase in inventory	(5,000)
Decrease in receivables	6,000
Increase in payables	3,000
Cash generated from operations	174,000
Interest paid	(12,000)
Taxation paid	<u>(13,000)</u>
Net cash from operating activities	<u>149,000</u>

References

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