

**FINANCIAL ACCOUNTING
WEEK 10 (LECTURE TEN)**

PREPARATION OF THE STATEMENT OF CASH FLOWS

DR. JOHN MUHOHO

Learning Objectives:

Upon completion of this Lesson, you will be able to:

- Introduction to Cash Flow financial statements
- Understand the Cash Flow statement
- Explain the Types of Cash Flow Statements in practice
- Explain the need for Cash Flow statement
- Explain the components of a Cash Flow Statement
- Explain the Categories of the Cash Movement activities
- Prepare a Cash Flow Statement for enterprises

INTRODUCTION:

A business enterprise normally prepares the following two financial statements

- (i) Profit or loss or income statement which helps to find out the profit or loss made as result of operations of the company over a specified period.
- (ii) Balance sheet or financial position statement which reflects the state of asset and liabilities of company on a particular period.

Another required financial statement is cash flow statement. This is requirement of International Accounting 7 (IAS 7) which was elaborated earlier in this course. In this course we shall refer the Statement of Cash flow as SCF.

The Statement of Cash Flow is a financial statement that shows all sources of cash (Cash inflow) and all the avenues or avenues of spending the cash (Cash outflow). The SCF shows all cash into an entity and all cash out of an entity.

IMPORTANCE OF CASH AND CASH EQUIVALENCE TO AN ORGANIZATION

Cash is the most important measure of liquidity status of an organization. Cash is an important measure to an organization just as blood is to the body. Without cash, the organization will not be able to meet its obligations and will therefore be technically dead, because the organization ceases to be a going concern.

Cash is a necessary resource as well as a means for organisations to acquire more resources. For a well-managed cash resource, a company or organisation is able to buy assets, pay workers, service debt and regulate tasks. This cash management is an important and critical aspect in the whole area of working capital management.

A prudent working capital management allows a company to meet its maturing obligations as they fall due, thus ensuring stability.

$$\text{Cash ratio} = \frac{\text{Cash in hand/bank} + \text{short term marketable securities}}{\text{Current liabilities}}$$

This is a refinement of the acid test ratio indicating the ability of the firm to meet its current liabilities from its most liquid resources.

Short term marketable securities refers to short term investment of the firm which can be converted into cash within a very short period e.g commercial paper and treasury bills.

According to Keynes in his General Economic theory developed in 1990, business hold cash in order to fulfill various motives as follows; Precautionary motive, which means holding cash to meet future emergencies that may arise, transaction motive which means holding cash to meet current business operations needs and speculative motive which entails holding cash with the objective of securing profits or enabling an organization to be in a position to take advantage of emerging business opportunities.

Cash which is an internal source of financing is the cheapest source of financing in the organisation's capital structure and according Pecking Order Theory, which was proposed by

Myers and Mailuf (1984) , firms should opt to using internal financing to debt and equity financing as it is a cheaper source of financing.

NEED FOR CASH FLOW STATEMENT

Users of financial statements, require understanding how the business generated cash and how the cash was used. Unlike the income statement where profit reported is influenced by accounting policies and estimates, cash flow indicates the performance of the business enterprise without such influences, therefore provide a better perspective to evaluating the performance.

Remember that a business enterprise can be making profits, while at the same time suffering from cash crisis. This can lead to business enterprise wind up.

Indirect Method for Preparing the Cash Flow Statement

COMPONENTS OF A CASH FLOW

Cash flow statement summaries the cashbook, by reconciling the opening and closing balance of the cash and cash equivalents. Cash equivalents refer to liquid assets which can easily be transferred into cash and include;

- (i) Cash
- (ii) Demanded deposits in banks
- (iii) Short term investments
- (iv) Bank overdraft

The cash movement activities are classified into 3 categories

- (i) Operating cash movement/ activities
- (ii) Investing cash movement/ activities
- (iii) Financial cash movement/ activities

a) Operating Activities

These are the core activities of any business. They reflect the main or ordinary business activities. They indicate the net amount generated from business customers, after meeting all the necessary expenses to raise that revenue. Operating cash flows are most importance because they indicate ability of the business to sustain its activities Operating cash flow can be determined directly or indirectly

(i) Directly;

Cash received is compared with cash paid in ordinary activities of business, which can be determined from cash book or from control ledger. The format is as follows:

<i>Cash paid for operating expense</i>	(XX)
	XX

(ii) Indirectly:

Companies may choose to use either the direct method or the indirect method when preparing the SCF section cash flows from operating activities. However, the indirect method is the dominant method used and the one we will explain. Under the indirect method, the SCF section cash flows from operating activities begins with the amount of net income, which is taken from the company's income statement. Since the net income was based on the accrual method of accounting, the amount of net income must be adjusted to the cash amount. If an adjustment to the amount of net income is in parentheses, it is subtracted from net income. It indicates that the cash amount was less than the related amount on the income statement. Adjustments in parentheses can also be interpreted to be unfavorable for the company's cash balance.

An adjustment to net income that is not in parentheses is a positive amount, which indicates the cash amount was more than the related amount on the income statement. A positive adjustment can also be interpreted to be favorable for the company's cash balance. Under this method operating profits is reconciled with operating cash flow. Operating profit is profit before interest and tax (EBIT) which is adjusted with non -cash flow items. Non-cash items are as given below.

(i) Non-cash expenses

(ii) Prepayments

Cash received from customer	XX
Cash received from other operating income	XX
Cash paid to supplies	(XX)
Cash paid to employee	(XX)

These are items subtracted from P&L but do not involve payment. As a result, they should be added back. They include: depreciation, impairment losses, and losses on disposal among others.

These refer to any cash paid in a period before it is recognized in the P&L statement. Mainly entail use of cash but no effect on profit as a result they should therefore be subtracted.

Examples include-

- Increase in debtors:
- Increase in stock
- Increase in bills receivables

- Decrease in creditors
- Decrease in bills payables

(iii) Accruals

They refer to revenues or expenses in the P&K recognized without necessary receiving /paying cash. As result they should be added back They include:

- Decrease in stock,
- Decrease in debtors
- Decrease in bills receivables
- Increase in bills payables
- Increase in creditors

(iv) Investing activities:

Refer to cash generated or used in relation to fixed assets. Fixed assets investments define capacity to generate revenue. The capacity should be continuously enhanced and where necessary renewed. The investing activities section of the SCF reports the cash inflows and cash outflows related to the changes that occurred in the noncurrent (long-term) assets section of the balance sheet.

Examples of investing activities include the following:

- Capital expenditures (additions to property, plant and equipment)
- Proceeds from the sale of property, plant and equipment
- Purchase of long-term investments
- Proceeds from the sale of long-term investments

(v) Financing activities

Refer to cash generated or used in relation to long-term source of capital due as issues of shares, repayments of lower and debtors among others.

The cash inflows and outflows from financing activities are related to the changes in the following balance sheet sections:

- Noncurrent (long-term) liabilities
- Stockholders' equity (or owner's equity)
- Loans and similar debt reported under current liabilities

Examples of the descriptions and amounts typically reported under cash flows from financing activities include the following:

- Proceeds from long-term debt

- Repayment of long-term debt
- Proceeds from issuing capital stock
- Payment of dividends
- Purchase of treasury stock
- Change in short-term debt

FORMAT OF CASH FLOW STATEMENT

ABC LTD

CASH FLOW STATEMENT

FOR THE YEAR ENDED 31 December 2022

	\$.	\$.	
Retained profit for the year		XX	
Add non-cash expenses			
Depreciation		XX	
Tax provision		XX	
Proposed dividends		XX	
Add Accruals			
Decrease in debtors		XX	
Decrease in stock		XX	
Decrease in Bill receivable		XX	
Increase in creditors		XX	
Less prepayment			
Increase in stock		(XX)	
Increase in bill receivable		(XX)	
Decrease in creditors		(XX)	
Decrease in bill payable		<u>(XX)</u>	
Net cash inflow/outflow from operating activities			XX
Interest paid/received		XX	
Dividend paid/received		XX	
Net cash flow inflow/outflow from investing Activities			
Sales of fixed assets	XX		
Purchase of fixed assets	(XX)	XX	
Net cash flow/ outflow for financing activities			

Issues of shares	XX	
Issue of debtors	XX	<u>XX</u>
Increase in cash/ cash equivalent		<u>XX</u>

ILLUSTRATION ONE

The following information was extracted from the records of Doverin Company Limited for the year ended: 31st December 2022.

DOVERIN LIMITED STATEMENT OF FINANCIAL POSITION AS AT 31/12/2022

	31/12/2021	31/12/2022
	\$ '000'	\$ '000'
Issued share Capital	18,000	23,000
Retained Profits	7,500	9,200
10% Debentures	6,000	7,500
Taxation payable as at 1 st January	2,900	3,200
Creditors (Accounts Payables)	3,200	3,400
Proposed Dividends	<u>500</u>	<u>600</u>
	<u>38,100</u>	<u>46,900</u>
Non-Current Assets at cost	23,000	25,000
Depreciation	<u>(5,650)</u>	<u>(6,200)</u>
	17,350	18,800
Inventory	12,000	14,695
Debtors (Accounts Receivables)	4,200	4,150
Balance at Bank	<u>4,550</u>	<u>9,255</u>
	<u>38,100</u>	<u>46,900</u>

Required:

Using the information provided, Prepare the Cash Flow Statement for Doverin Co. Limited for the given period:

SUGGESTED SOLUTION (INCLUDING WORKINGS)

**DOVERIN LIMITED
STATEMENT OF CASHFLOW
FOR PERIOD ENDED 31/12/2022**

	\$ '000'	\$ '000'
Cash Flow from Operating Activities		
Net Profit After Tax & Interest (PAT)	1,700	
<i>Add: Non-cash expenses:</i>		
Depreciation	2,650	
Proposed Dividends	3,200	
Proposed taxation	600	
<i>Less Non-Cash Income</i>		
Profit on sale of Non-Current Assets	(1,000)	
Add Accruals:		
Decrease in Debtors	50	
Increase in Creditors	200	
Less Prepayments:		
Increase in Inventory	<u>(2,695)</u>	
Net Cash Flow Inflow from Operating Activities		4,705
Interest Paid	(2,900)	
Dividend paid	<u>(500)</u>	1305
Net Cash Generated from investing Activities		
Disposal of Non-Current Assets	2,500	
Purchase of Non-current Assets	<u>(5,600)</u>	(3,100)
Net Cash generated from Financing Activities		
Issue of Ordinary share capital	5,000	
Issue of 10% Debentures	<u>1,500</u>	<u>6,500</u>

Changes in Cash & Cash Equivalent		<u>4,705</u>
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Reconciliation of Opening and closing Cash Balances:

	\$ '000)
Cash at bank on 1 st January 2022	4,550
Increase in Cash/Cash Equivalent	<u>4,705</u>
	<u>9,255</u>

WORKINGS & NOTES TO THE QUESTION

1. Determining if there was purchase or disposal of fixed asset

Non-Current Asset a/c

	\$'000'		\$ '000'
Jan Bal Ltd	2,300	Disposal Acc	3,600
Bank A/c	<u>5,600</u>	31 Dec Bal c/d	<u>2,500</u>
	<u>28,600</u>		<u>28,600</u>

ii) **Determining profit made on disposal of fixed assets**

Asset Disposal a/c

	\$ '000'		\$ '000'
Fixed asset Acc	3,600	Depreciation profit Acc.	2,100
P&LA/C	<u>1,000</u>	Bank Acc	<u>2,500</u>
	<u>4,600</u>		<u>4,600</u>

iii) **Accumulated depreciation a/c**

	\$ '000'		\$ '000'
		Jan 1 Bal b/f	5,650
Disposal	2,100		
Bal C/d	<u>6,200</u>	P&C Acc	<u>2,650</u>

	<u>8,300</u>		<u>8,300</u>
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iv) Stock

\$ '000'

Stock as at 31/Dec/2022 14,695

Stock as at 31/Dec/2021 12,000

Increase 2,695

v) Debtors

Debtors as at 31/Dec/2022 4,150

Debtors as at 21/Dec 2021 4,200

Decrease (50)

vi) Trade & Expense creditors

Creditors as at 21/Dec/2022 3,400

Creditors as at 31/Jan/2022 3,200

Increase 200

vii) *Deprecations is an expense which reduces profit, but does not involve cash outflow, hence added back*

viii) Taxation is paid in arrears i.e. tax for 2021 is paid in 2022, and for 2022 paid in 2023

As a result, tax expenses for 2022 do not involve cash in 2022; hence it is not cash flow in 2022. But tax for 2021 is cash flow in 2022, hence that why it is subtracted

NB:

Proposed dividends like tax are paid in arrears hence proposed dividend for 2021 are cash flow in 2022. Proposed dividends for 2022 will be cash Outflow in 2023 due to this we add back proposed dividend for 2021 as they are paid in 2022

The items taxation, interest and dividend are normally shown separately after net cash flow from operating activities but before net cash flow from investment.

ILLUSTRATION TWO

The following information was extracted from Tropical Limited a medium sized company in Nairobi Kenya for the years 2020 and 2021.

	2021	2020
	\$ '000'	\$ '000'
Non-Current Assets	8,520	7,000
Current Assets		
Inventory	6,000	5,000
Debtors (Accounts Receivables)	1,750	1,800
Bank balance	<u>2,630</u>	<u>1,550</u>
	<u>10,380</u>	<u>8,350</u>
Current Liabilities		
Creditors	1,400	1,300
Tax	1,200	1,100
Proposed Dividends	<u>400</u>	<u>350</u>
	<u>3,000</u>	<u>2,750</u>
NET CURRENT ASSETS	<u>7,380</u>	<u>5,600</u>
NET ASSETS	<u>15,880</u>	<u>12,600</u>
Financed By:		
Equity & Revenue		

Ordinary Share Capital	9,000	7,000
Retained Earnings	3,880	3,200
Debentures Loan	<u>3,000</u>	<u>2,400</u>
	<u>15,880</u>	<u>12,600</u>

The following additional information is also given:

1. During the year ended 30th September 2021 fixed assets were purchased at a cost of Sh.2700,000 while fixed assets whose original cost was Sh.1000,000 were disposed for Sh 750,000 The net book value of the assets disposed were Sh.400, 000 and the profit on sale of the fixed asset has been included in the retained profits.
2. Accumulated depreciation at 30 September 2021 was Sh.2500, 000 and Sh 2300,000 at September 20

SUGGESTED SOLUTION:

Tropical Limited
Statement of Cash Flow
For year Ended 31/12/2021

	\$ '000'	\$ '000'
Net Cash Flow from Operating Activities		
Retained Profit for the year (3880-3200)	680	
Add: Non-Cash Expenses:		
Depreciation	800	
Tax Provision	1,200	
Less Non-Cash income:		
Profit on disposal of Assets	(350)	
Add Accruals:		
Decrease in Debtors	50	
Increase in Creditors	100	
Less Prepayments		
Increase I Inventory	<u>(100)</u>	
		(1,880)
Net Cash Flow from Investing Activities		
Disposal of Assets	750	
Purchase of Assets	<u>(2,700)</u>	
		(1,950)

Net Cash Flow From Financing Activities		
Issue of Ordinary shares	2,000	
Issue of Debentures	<u>600</u>	<u>2,600</u>
Increase in cash & Cash Equivalent		<u>1,080</u>

Reconciliation of Opening cash and Closing Cash Balance:

	\$.	'000'
Opening cash Balance	1,550	
Add increase in Cash & Equivalent	<u>1,080</u>	
	<u>2,630</u>	

USES OF CASH FLOW STATEMENTS

Cash flow statements have many uses other than the legal need for some companies to prepare them. A few cases where a business might find them useful is answering such questions as below- Small businessman may want to know why he now has an overdraft. He started off the year with money in the bank, he has made profit and yet he now has a bank overdraft. Another businessman may want to know why the bank balance has risen even though the business is losing money.

The partners in a business have put in additional capital during the year. Even so, the bank balance has fallen dramatically. They may want explanation as to how this has happened. A study of the final accounts themselves would not give them the information that they may needed. However, a study of the cash flow statement in each case will reveal the answer to their questions

Besides the answers to such specific queries, cash flow statement should also help businesses to assess the following.

- The cash flows which the business may be able to generate in the future;

- How far the business will be able to meet future commitment, e.g. tax due, loan repayments, interest payments, contracts that could possibly lose quite a lot of money;
- How far future share issues may be needed or additional capital in the case of sole trader or partnership;
- A valuation of the business

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