

Chapter

4

Statement of Cash Flows For Single Company

4.1 Single company statement of cash flows

Statement of cash flows are primary financial statements and are required along side the income statement and statement of financial position. Cash is the fuel of a business, without which business will suffer financial stress.

A business can be a very profitable one, but if it's unable to generate cash as quickly as it is generating profits, then it will face problems (how will it pay its suppliers and employees?).

IAS 7 deals with statement of cash flows; it's a period statement and shows all the cash inflows and outflows during the accounting period.

Statement of cash flows provides users information, which is not available from statement of financial position and income statement.

The statement of cash flows helps users of the accounts in assessing how well the business is generating cash.

It shows the relationship between the profitability and cash generated, therefore comparisons can be made with other organisations, without having to worry about different accounting policies (which affect the profit figure)

The statement of cash flows will also show how liquid the business is and from past statement of cash flows, the history can be established, which will highlight any problems to the user of the accounts.

Format of statement of cash flows

The main headings of the statement of cash flows as per IAS 7 are:

Cash flow from **operating** activities

Cash flow from **investing** activities

Cash flow from **financing** activities

Net increase 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

It is necessary to group cash flows in the main 3 headings according to whether they relate to operating, investing or financing activities. Under the main headings will be details of the individual types of cash flows

Let's now look at each of the main headings in details

1 Cash flow from operating activities

The cash flows from the businesses core activities are detailed here. There are 2 methods which IAS 7 allows in calculating cash flow from operating activities:

Method 1 – Direct method

The direct method shows operating cash receipts and payments made during the period. To the users of the account this gives details of exactly where the cash has come from and where it has been spent.

Cash flows from operating activities	\$
Cash received from customers	X
Cash paid to suppliers and employees	(X)
Other operating expenses	(X)
Cash generated from operations	X
Interest paid	(X)
Income taxes paid	(X)
Dividends paid	(X)
Net cash flow from operating activities	<u>X</u>

The information required for the direct method can usually be obtained from accounting records.

Method 2 – Indirect method

The indirect method is what you will probably be familiar with. It requires a lot less information to produce it, and therefore can be argued to be the easier method.

With the indirect method, the profit before taxation (or profit before interest and tax) is taken from the income statement and adjusted for non cash items (i.e. depreciation, provisions). It is also adjusted for profit or loss on disposal of assets. Other items which will be classified under investing or financing are also adjusted for. Finally adjustments are made for the changes during the period in inventories, trade and other receivables and payables. This requires looking at the current and prior year's statement of financial position.

<u>Indirect method</u>	\$
**Profit before taxation	X
Adjustment for:	
Depreciation and amortisation	X
Finance cost	X
Interest income	(X)
Profit on sale of asset	(X)
Working capital changes	
(Increase) decrease in inventories	(X) / X
(Increase) decrease in trade and other receivables	(X) / X
Increase (decrease) in trade payables	X / (X)
Cash flow from operating activities	X
Interest paid	(X)
Income taxes paid	(X)
Dividends paid	(X)
Net cash flow from operating activities	<u>X</u>

** Profit before interest and taxation can also be used here as well as profit for the period. Whichever figure is taken it's important than to adjust for the relevant items accordingly (i.e. if using profit for the year adjust for income tax expense and finance charge shown in the income statement ó the cash outflows for these are then calculated later on the statement of cash flows).

Movements in working capital

The year-end balances of inventories, trade and other receivables and payables are taken for current year-end and last year-end statement of financial position

	<u>Decrease</u>	<u>Increase</u>
Inventories	Cash inflow	(Cash outflow)
Receivables	Cash inflow	(Cash outflow)
Payables	(Cash outflow)	Cash inflow

- An increase in inventories means that more cash has been spent to acquire the inventories; therefore it is a cash outflow.
- A decrease in inventories means less cash has been used to acquire inventories; therefore it is a cash inflow.
- An increase in trade receivables means that more credit customers are taking credit or taking longer to pay, which means less cash for the company, therefore cash outflow.
- A decrease in trade receivables means less credit customers, therefore cash inflow.
- A decrease in trade payables means the business is paying the suppliers quicker, resulting in cash outflow.
- An increase in trade payables means the business is taking longer to pay the suppliers, therefore holding the cash in the business longer, meaning it's a cash inflow.

2 Cash flow from investing activities

The items included in this heading are:

<u>Cash payments</u>	<u>Cash receipts</u>
Acquiring property, plant and equipment	Sale of property, plant and equipment
Capitalising developing expenditure and cash payments for other intangible assets	Sale of shares in other entities
Acquisition of shares (equity) in other entities	

3 Cash flows from financing activities

The items included in this heading are:

<u>Cash receipts</u>	<u>Cash payments</u>
Cash receipts from issuing new shares (rights or full market issue)	Cash payments to redeem debt
Cash received from issuing debentures, bonds or from a loan (short and long term)	Cash payments to redeem or buy back shares
	Capital repayment of a finance lease

4 Dividends and interest payments

The payment of dividends and interest can either be shown under financing activities or under operating activities.

The sum of the 3 main heading shows the net increase or decrease in cash during the period, the opening and closing balances of cash and cash equivalents complete the statement of cash flows.

Cash and cash equivalents include:

- Bank and cash balances
- Short term investments which are highly liquid and can be converted into cash within 3 months. Cash equivalents will be shown under current assets in the statement of financial position.

4.2 The calculations for the cash flows

The actual amount of cash paid or received during the period needs to be established. This can get quite tricky as there will be accruals brought forward, carried forward and prepayments brought forward and carried forward. There will also be transactions which do not affect cash flow like depreciation and re-valuations.

The best way of doing this is to set up a $\delta T \delta$ account, fill in all the relevant information and the balancing figure will be the cash figure. For the direct method, $\delta T \delta$ accounts can also be used to establish cash payments to suppliers, receipts from customers etc.

Examples of $\delta T \delta$ accounts to establish cash flow

1 Non-current assets

Non-current assets (net book / carrying value)			
Bal b/f	X	Disposals	X
Revaluations	X	Depreciation	X
Finance leases	X	Impairments	X
<i>Additions (bal fig) cash paid</i>	X		
		Bal c/f	X
<u>Total</u>	<u>X</u>	<u>Total</u>	<u>X</u>

2 Interest payable

Interest payable			
		Bal b/f	X
<i>Cash paid (bal fig)</i>	X	Income statement charge for the year	X
Bal c/f	X		
	-		
<u>Total</u>	<u>X</u>	<u>Total</u>	<u>X</u>

3 Interest receivable

Interest receivable			
Bal b/f	X		
Income statement	X	<i>Cash received (bal fig)</i>	X
		Bal c/f	X
<u>Total</u>	<u>-</u> <u>X</u>	<u>Total</u>	<u>-</u> <u>X</u>

Hint: For assets balances **bought forward** are always on the **debit side** (therefore balances carried forward on the opposite credit side). For **liabilities** balances bought forward are always on the **credit side** (therefore balances carried forward on the debit side).

Lecture example 4.1

The opening balance for property, plant and equipment account was £85 million (carrying value) and the closing balance was £150 million (carrying value).

During the year disposal was:

	£m
Original cost	10
Accumulated depreciation	8
Sales proceeds	3

- Revaluation of property resulted in an increase of £2 million.
- New finance leases of £16 million were also capitalised.
- Depreciation of £15 million was charged to the income statement for the period.

What is the cash flow that will appear in investing activities in the statement of cash flows relating to non-current assets?

Lecture Example 4.2

The following are extracts from Grant plc financial statements

Statement of financial position	20X6	20X5
	£000	£000
<u>Current assets</u>		
Investment income receivable	25	15
<u>Liabilities</u>		
Defer taxation	80	50
Income tax payable	850	800
Interest payable	500	450
Income statement for period ending 20X6	£000	
Investment income	40	
Interest payable	800	
Income tax expense	900	

What are the cash flows that would be appear in the statement of cash flows for Grant plc for year ending 20X6?

Lecture Example 4.3

The following are extract financial statements of Ali Ltd

Income statement for year ending 31st March 20X5

	£000
Sales revenue	5,200
Cost of sales	<u>(3,000)</u>
Gross profit	2,200
Admin and selling expenses	<u>(900)</u>
Operating profit	1,300
Interest expense	(200)
Investment income	<u>500</u>
Net profit before tax	1,600
Income tax expense	<u>(300)</u>
Profit for the year	1,300
Dividends	<u>(500)</u>
Retained profit for the year	<u>800</u>

Statement of financial position extracts as at:

	20X5	20X4
	£000	£000
<u>Current assets</u>		
Inventories	2,000	2,500
Receivables	1,500	1,375
<u>Current liabilities</u>		
Trade payables	(1,400)	(1,875)
Income tax	(100)	(200)

Other information

Depreciation of £50,000 has been charged to the cost of sales in the income statement.

Requirement

Calculate the operating cash flow as per IAS 7 using the direct method

(Assume that interest expense is part of the operating activities)

Step by step approach to completing a statement of cash flows

Step 1	Set out pro forma, using a whole side of paper leaving lots of spaces between the 3 main headings of operating, investing and financing activities.
Step 2	Set up a workings page and read through all the additional information. Also make notes to see how they affect the statement of cash flows.
Step 3	Complete the operating activities section (using the method instructed by the question either direct or indirect). Incorporating interest and taxation cash flows if necessary.
Step 4	Complete the investing activities section by looking at the non current assets. Make sure you take account of both tangible and intangible non current assets.
Step 5	Complete the financing section by looking at share capital, long term debt and capital element of finance leases.
Step 6	Finally review the income statement and statement of financial position to ensure all items have been dealt with. Complete the remaining statement of cash flows, and double check that the increase or decrease in cash and cash equivalents during the period, corresponds to the movement in cash and cash equivalent balances in the 2 statement of financial position.

Lecture Example 4.4

The summarised accounts of the Comworld plc for the year ended 31 December 20X4 are as follows:

Statement of financial position at 31 December:

	20X4		20X3	
	£000	£000	£000	£000
<u>Non-current assets</u>				
Plant, property and equipment		628		514
<u>Current assets</u>				
Inventories	214		210	
Trade receivables	168		147	
Bank	<u>7</u>		<u>-</u>	
		<u>389</u>		<u>357</u>
		<u>1,017</u>		<u>871</u>
<u>Capital and reserves</u>				
Share capital (£1 ordinary shares)		250		200
Share premium account		70		60
Revaluation reserve		110		100
Profit and loss account		<u>314</u>		<u>282</u>
		<u>744</u>		<u>642</u>
<u>Non-current liabilities</u>				
10% debentures		80		50
<u>Current liabilities</u>				
Trade payables	136		121	
Income tax payable	39		28	
Dividends payable	18		16	
Bank Overdraft	<u>-</u>		<u>14</u>	
		<u>193</u>		<u>179</u>
		<u>1,017</u>		<u>871</u>
Income statement for year ending 31st December 20X4				
Sales revenue				600
Cost of sales				<u>(319)</u>
Gross profit				281
Other operating expenses				<u>(186)</u>
Operating profit				95
Interest payable				<u>(8)</u>
Profit before tax				87
Income tax				<u>(31)</u>
Profit after tax				56
Dividends				<u>(24)</u>
Retained profit for the year				<u>32</u>

Other information

- Other operating expenses include depreciation of £42,000.
- There have been no disposals of non-current assets during the year.

Requirement

Prepare a statement of cash flows in accordance with IAS 7, using the indirect method.

Key summary of chapter “statement of cash flows for single company”

IAS 7 deals with statement of cash flows; it is a period statement and shows all the cash inflows and outflows during the accounting period.

Statement of cash flows provides users information, which is not available from statement of comprehensive income and statement of financial position.

The statement of cash flows helps users of the accounts in assessing how well the business is generating cash.

It shows the relationship between the profitability and cash generated; therefore comparisons can be made with other organisations, without having to worry about different accounting policies (which affect the profit figure)

The statement of cash flows will also show how liquid the business is and from past cash flow statements, the history can be established, which will highlight any problems to the user of the accounts.

Format of statement of cash flows

The main headings as per IAS 7 are:

Cash flow from **operating** activities

Cash flow from **investing** activities

Cash flow from **financing** activities

Net increase 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

Cash flow from operating activities - there are 2 methods which IAS 7 allows in calculating cash flow from operating activities:

Method 1 – Direct method

The direct method shows operating cash receipts and payments made during the period. To the users of the account this gives details of exactly where the cash has come from and where it has been spent.

Cash flows from operating activities	\$
Cash received from customers	X
Cash paid to suppliers and employees	(X)
Other operating expenses	<u>(X)</u>
Cash generated from operations	X
Interest paid	(X)
Income taxes paid	(X)
Dividends paid	<u>(X)</u>
Net cash flow from operating activities	<u>X</u>

Method 2 – Indirect method

With the indirect method, the profit before taxation (or profit before interest and tax) is taken from the statement of comprehensive income and adjusted for non cash items (i.e. depreciation, provisions). It is also adjusted for profit or loss on disposal of assets. Other items which will be classified under investing or financing are also adjusted for. Finally adjustments are made for the changes during the period in inventories, trade and other receivables and payables. This requires looking at the current and prior year's statement of financial position.

Indirect method	\$
**Profit before taxation	X
Adjustment for:	
Depreciation and amortisation	X
Finance cost	X
Interest income	(X)
Profit on sale of asset	(X)
Working capital changes	
(Increase) decrease in inventories	(X) / X
(Increase) decrease in trade and other receivables	(X) / X
Increase (decrease) in trade payables	<u>X / (X)</u>
Cash flow from operating activities	X
Interest paid	(X)
Income taxes paid	(X)
Dividends paid	<u>(X)</u>
Net cash flow from operating activities	<u>X</u>

Cash flow from investing activities

The items included in this heading are:

- Acquiring property, plant and equipment.
- Capitalising developing expenditure and cash payments for other intangible assets
- Acquisition of shares (equity) in other entities
- Sale of property, plant and equipment
- Sale of shares in other entities

Cash flows from financing activities

The items included in this heading are:

- Cash receipts from issuing new shares (rights or full market issue).
- Cash received from issuing debentures, bonds or from a loan (short and long term)
- Cash payments to redeem debt.
- Cash payments to redeem or buy back shares.
- Capital repayment of a finance lease.

Dividends and interest payments

The payment of dividends and interest can either be shown under financing activities or under operating activities.

Cash and cash equivalents include bank & cash balances, short term investments which are highly liquid and can be converted into cash within 3 months. Cash equivalents will be shown under current assets in the balance sheet.

Using T-accounts helps establishing cash flows.

Adopt a step by step technique for maximising marks.

Solutions to Lecture Examples

Solution to Lecture example 4.1			
Non-current assets (carrying value)			
	£m		£m
Bal b/f	85	Disposals (10-8)	2
Revaluations	2	Depreciation	15
Finance leases	16		
<i>Additions (bal fig) cash paid</i>	<i>64</i>		
	-	Bal c/f	150
<u>Total</u>	<u>167</u>	<u>Total</u>	<u>167</u>
Cash flow will be			
Cash additions	(£64) m		
Sales proceeds	<u>£ 3 m</u>		
Net cash outflow	<u>(£61) m</u>		

Solution to Lecture Example 4.2			
Income tax (IT) payable and defer tax (DT)			
		Bal b/f - IT	800
		Bal b/f ó DT	50
<i>Cash paid (bal fig)</i>	<i>820</i>	Income statement charge for the year	900
Bal c/f ó IT	850		
Bal c/f ó DT	<u>80</u>		-
<u>Total</u>	<u>1,750</u>	<u>Total</u>	<u>1,750</u>

Interest payable			
		Bal b/f	450
<i>Cash paid (bal fig)</i>	<i>750</i>	Income statement charge for the year	800
Bal c/f	500		
	-		-
<u>Total</u>	<u>1,250</u>	<u>Total</u>	<u>1,250</u>

Solution to Lecture Example 4.2 cont.....

Investment income receivable

Bal b/f	15		
		<i>Cash received (bal fig)</i>	30
Income statement	40		
		Bal c/f	25
	-		-
Total	<u>55</u>	Total	<u>55</u>

Solution to Lecture Example 4.3

<u>Cash flow from operating activities (direct method)</u>	£000
Cash received from customers (W1)	5,075
Cash paid to suppliers (W2)	(2,925)
Cash paid for other operating expenses (W3)	(900)
Cash generated from operations	1,250
Interest paid (W4)	(200)
Income taxes paid (W5)	(400)
<u>Net cash flow from operating activities</u>	<u>650</u>

Working 1 ó Cash received from customers

Trade receivables

Bal b/f	1,375		
Income statement revenue	5,200	<i>Cash received (bal fig)</i>	5,075
		Bal c/f	1,500
	-		-
Total	<u>6,575</u>	Total	<u>6,575</u>

Solution to Lecture Example 4.3 cont.....

Working 2- Cash paid to suppliers

This requires 2 workings. Firstly establish the purchases for the year using the cost of sales and opening and closing inventory, then from the trade payables establish how much has been paid to suppliers.

Inventories

Bal b/f	2,500	Income statement cost of sales	3,000
<i>Purchases (bal fig)</i>	<i>2,500</i>	Bal c/f	2,000
	<u>-</u>		<u>-</u>
<u>Total</u>	<u>5,000</u>	<u>Total</u>	<u>5,000</u>

But the cost of sales includes depreciation of £50,000, so therefore the correct purchases for the year are:

$$£2,500,000 \ominus 50,000 = \mathbf{£2,450,000}$$

Trade payables

		Bal b/f	1,875
<i>Cash paid (bal fig)</i>	<i>2,925</i>	Purchases	2,450
Bal c/f	1,400		
	<u>-</u>		<u>-</u>
<u>Total</u>	<u>4,325</u>	<u>Total</u>	<u>4,325</u>

Working 3 ó Cash for other operating expenses are for admin and other expenses. As there is no accruals b/f or c/f, the cash paid is the charge to the income statement.

Working 4 ó Interest expenses have no accruals b/f or c/f, so therefore charge to the income statement is the cash paid. The other option could be to include it in as part of financing activities and not operating activities.

Working 5 ó income taxes paid

Income taxes

		Bal b/f	200
<i>Cash paid (bal fig)</i>	<i>400</i>	Income statement charge for the year	300
Bal c/f	100		
	<u>-</u>		<u>-</u>
<u>Total</u>	<u>500</u>	<u>Total</u>	<u>500</u>

Solution to Lecture Example 4.4 - Comsworld

Statement of cash flows for Comsworld for year ending 31/12/X4	£'000	£'000
<u>Cash flow from operating activities</u>		
Operating profit	95	
+ Depreciation	42	
Increase in inventory	(4)	
Increase in trade receivables	(21)	
Increase in trade payables	<u>15</u>	
Operating cash flow	127	
Interest paid (no accruals b/f or c/f)	(8)	
Income taxes paid (W1)	<u>(20)</u>	
Net cash flow from operating activities		99
<u>Cash flow from investing activities</u>		
Purchase of non-current assets (W2)	(146)	
Net cash outflow from investing activities		(146)
<u>Cash flow from financing activities</u>		
Issue of share capital (W3)	60	
Issue of debentures (80-50)	30	
Equity dividends paid (W4)	<u>(22)</u>	
Net cash inflow from financing activities		68
Net increase in cash and cash equivalents		21
Cash and cash equivalents at 1st January 20X4		<u>(14)</u>
Cash and cash equivalents at 31st December 20X4		<u>7</u>

Working 1 - Taxation

Tax payable

	£000		£000
Bal fig. = tax paid	20	Balance b/f	28
Balance c/f	<u>39</u>	Charge for year	<u>31</u>
	<u>59</u>		<u>59</u>

Working 2 - Non-current assets

Non current assets

	£000		£000
Bal b/f	514	Bal c/f	628
Bal fig. additions	146	Depreciation	42
Revaluation	<u>10</u>		<u>-</u>
	<u>670</u>		<u>670</u>

Solution to Lecture Example 4.4 – Comsworld cont.....

Working 3 - Share capital

Look at both share capital and share premium accounts.

Share capital and share premium

	£000		£000
Balance c/f (250 + 70)	<u>320</u>	Balance b/f (200 + 60)	260
	<u>320</u>	Bal fig. = cash received	<u>60</u>
			<u>320</u>

Working 4 - Dividends

Dividends payable

	£000		£000
Bal fig = dividends paid	22	Balance b/f	16
Balance c/f	<u>18</u>	Dividend for year	<u>24</u>
	<u>40</u>		<u>40</u>