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The Cashflow Statement an International Perspective

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The notion of cash flow and funds flow has been included in accounting standards for almost three decades. For example in the UK, SSAP 10 (1976), Source and Application of Funds Statement, was an early attempt by standard setters to provide a link between the balance sheet at the start of the accounting period, the profit and loss for the period and the balance sheet at the end of the period.

When the Accounting Standards Board in the UK, took over the work of the Accounting Standards Committee in 1991, its first significant revision was to replace SSAP 10 by FRS 1, Financial Reporting Standard 1, Cash Flow Statement. This transition from funds flow to cash flow was also reflected in the revision of the IASC's, International Accounting Standards Committee, IAS 7, Statement of Changes in Financial Position (1977) to IAS 7 Cash Flow Statement (1992) which became operative for financial statements covering periods beginning on or after 1 January 1994.

Readers will be aware that International Financial Reporting Standards (IFRS's) including the IAS's are to be adopted by all listed companies in the EU from 1 January 2005.

IAS 7 requires enterprises to present a cash flow statement as part of their financial statements.

A cash flow statement is needed as a consequence of the difference between profits and cash and thus provide the user with a facility for:

- assessing the current liquidity of a business
- providing additional information on business activities
- providing an overview of the major sources of cash inflow and outflow from the business
- a guide to estimate future cash flows; and
- determining cash flows generated from trading as opposed to other sources of finance

The purpose of the statement is to provide information on changes in cash and cash equivalents and to classify cash flow under three standard headings:

- Operating Activities
- Investing Activities
- Financing Activities

and to determine whether the operating activities reveal a positive cash flow, whether the overall activities yield a positive cash flow and the manner in which such activities have been funded.

What items comprise these standard headings and thus net cash flow from each?

Paragraph 6 in the standard defines these as:

"Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities".

"Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents".

“Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity”.

The standard details two formats:

- Direct Method
- Indirect Method

However paragraph 19 states that “entities are encouraged to report cash flows from operating activities using the direct method”.

The case study that follows illustrates both formats:

Cadeby Quarries Plc accounts for years ended 31 March 2004 and 2005 showed:

Balance Sheet

	2004 $000's	**2005 $000's**
Non-current Assets	145000	150000
Current Assets		
Inventories	49000	53000
Receivables	68000	73000
Cash at Bank	2500	4500
Total Assets	264500	280500
Shareholders' Equity		
Issued Share Capital	100000	100100
Reserves	52200	65300
	152200	165400
Non-current Liabilities		
10% Loan Notes	40000	43000
Current Liabilities		
Payables	63800	62000
Tax payable	4500	5900
Dividends payable	4000	4200
Total liabilities and shareholders' equity	264500	280500

Extract from the Income Statement year ended 31 March 2005

	$000's
Revenue	390000
Profit from operations	27500
Net interest cost	4300
Profit before taxation	23200
Income tax expense	5900
	17300
Dividends	4200
Net profit for period	13100

NB: The depreciation charge for the year was $12m

Non-current assets disposed in the year – proceeds $0.6m, depreciation to date $0.35m and initial cost $1.0m.

Cash Flow Statement (Direct Method)

		$000's
	Cash Flows from Operating Activities	
(1)	Cash receipts from customers	385000
(2)	Cash paid to suppliers and employees	(356250)
	Cash generated from operations	28750
(3)	Interest paid	(4300)
(4)	Income taxes paid	(4500)
	Net cash flow from operating activities	19950
	Cash Flows from Investing Activities	
(5)	Purchase of non-current assets	(17650)
(6)	Proceeds of sale, non-current assets	600
	Net cash used in investing activities	(17050)
	Cash Flows from Financing Activities	
(7)	Proceeds from issue of share capital	100
(8)	Proceeds from long-term borrowings	3000
(9)	Dividends paid*	(4000)
	Net cash used in financing activities	(900)
	Net increase in cash and cash equivalents	2000
(10)	Cash and cash equivalents at beginning of period	2500
(11)	Cash and cash equivalents at end of period	4500

*Dividends can also be classified in operating activities

Workings

The following are given as a guide to the figures shown on the cash flow statement:

Notes

Loss on sale of non-current assets:

	$000's
Cost	1000
Depreciation	350
NBV	650
Proceeds	600
	50

(1) Cash receipts from customers

	$000's
Opening receivables	68000
Revenue (Income Statement)	390000
	458000
Closing receivables	73000
	385000

(2) Cash paid to suppliers and employees

		$000's
Cost of sales		
Revenue		390000
Less profit from operations		27500
		362500
This includes:		
Depreciation	12000	
Loss on disposal	50	
Non-cash items		(12050)
		350450
Stock adjustment inventories (53000 – 49000)		4000
		354450
Opening payables		63800
Cost of sales adjusted (see above)		354450
		418250
Closing payables		62000
		356250

(3) Interest paid (figure per income statement) 4300

(4)	Income taxes paid	4500
		$000's
	Opening liability tax payable	4500
	Provision shown in income statement	5900
		10400
	Closing liability tax payable	(5900)
	Amount paid over in year	4500
(5)	Purchase of non-current assets	
		$000's
	Non-current assets	
	Opening (NBV) – Balance Sheet	145000
	NBV of disposal (1000 – 350)	650
		144350
	Depreciation for year	12000
		132350
	Closing NBV (Balance Sheet)	150000
	Purchases of non-current assets	17650
(6)	Proceeds (see footnote to income statement)	6000
		$000's
(7)	Proceeds from issue of share capital	100
	See Balance Sheet Issued share capital 2004-2005 difference (100100 – 100000)	
(8)	Proceeds from long-term borrowings	3000
	See Balance Sheet Increase in value of 10% Loan Notes (43000 – 40000)	
(9)	Dividends paid The classification of this item is optional, it can be shown under operating or financing activities.	
		$000's
	Opening liability dividends payable	4000
	Provision see Income Statement	4200
		8200
	Closing liability dividends payable	(4200)
	Paid in year	4000
(10)	See Current Asset (Balance Sheet)	**$000's**
	Cash at Bank 2004	2500
(11)	See Current Asset (Balance Sheet)	
	Cash at Bank 2005	4500

Cash Flow Statement (Indirect Method)

	Cash Flows from Operating Activities	**$000's**
(1)	Profit before tax	23200
(2)	Adjustments for:	
	Depreciation	12000
	Loss on sale non-current asset	50
(3)	Interest expense	4300
		39550
(4)	Increase in receivables	(5000)
(5)	Increase in inventories	(4000)
(6)	Decrease in payables	(1800)
	Cash generated from operations	28750
	Interest paid	(4300)
	Income taxes paid	(4500)
	Net cash from operating activities	19950
	Cash Flow from Investing Activities	
	Purchase of non-current assets	(17650)
	Proceeds of sale, non-current assets	600
	Net cash used in investing activities	(17050)
	Cash Flow from Financing Activities	
	Proceeds from issue of share capital	100
	Proceeds from long-term borrowings	3000
	Dividends paid*	(4000)
	Net cash used in financing activities	(900)
	Net increase in cash and cash equivalents	2000
	Cash and cash equivalents at beginning of period	2500
	Cash and cash equivalents at end of period	4500

*Dividends could also be shown as operating cash flow

Notes

(1) Profit before tax is taken from the Income Statement.

(2) These two items are <u>non-cash</u> and therefore need adding back to profit.

(3) Interest expense is also added back to arrive at a profit figure before the interest charge as the interest is then shown below as a cash outflow.

(4) (5) (6) The increase/decreases in the three key items of working capital – receivables, inventories and payables are taken from comparing the opening and closing balances shown on the Balance Sheet.

You will have noted that the significant difference between the two formats is the section on cash flows from operating activities.

Paragraph 18 in the standard states "an entity shall report cash flows from operating activities using either:

(a) The direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) The indirect method, whereby 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."

It is interesting to note that the standard encourages the use of the direct method.

Research suggests that previously in the UK where the ASB's FRS 1 cash flow statement was used the most widely published format was the indirect method.

Internationalisation and the global focus on harmonisation and the use of IFRS's in an exciting development which faces the profession and one which the student of accounting needs to address with enthusiasm.