Harvest Training and Consultancy Uganda Ltd.

trainers & bookkeepers

FINANCIAL ACCOUNTING - PAPER 1

UNIT 21 - CASH FLOW STATEMENTS

CPA Uganda

21.0
IAS 7 "*CASH FLOW STATEMENTS*"

UNIT 7 OVERVIEW:
- IAS 7 Statement of cash flows
- Preparing a statement of cash flows
- Interpretation of statements of cash flows

1.1 IAS 7 Statement of cash flows

Statements of cash flows are a useful addition to the financial statements because it is recognized that accounting profit is not the only indicator of a company's performance.

1.2 Introduction

It has been argued that 'profit' does not always give a useful or meaningful picture of a company's operations. Readers of a company's financial statements might even be misled by a reported profit figure.

(a) Shareholders might believe that if a company makes a profit after tax, of say, Shs.100 million then this is the amount which it could afford to pay as a dividend. Unless the company has sufficient cash available to stay in business and also to pay a dividend, the shareholders' expectations would be wrong.

(b) Employees might believe that if a company makes profits, it can afford to pay higher wages next year. This opinion may not be correct: the ability to pay wages depends on the availability of cash.

(c) Survival of a business entity depends not so much on profits as on its ability to pay its debts when they fall due. Such payments might include 'revenue' items such as material purchases, wages, interest and taxation etc, but also capital payments for new non-current assets and the repayment of loan capital when this falls due (for example on the redemption of debentures).

(d) The government revenue agencies e.g. URA may not listen to please by the organisation to extend its tax payment period basing on the high profit reflected on the profit and loss account. URA may not appreciate that the company may not be able to pay because the profitability does not correspond with the liquidity.

(e) Investors, public and government may think that a firm has made profits and that has the ability to pay its debts when they fall due.

From these examples, it may be apparent that a company's performance and prospects depend not so much on the 'profits' earned in a period, but more realistically on liquidity or cash flows.

1.3 Objective of IAS 7

The aim of IAS 7 is to provide information to users of financial statements about the entity's ability to generate cash and cash equivalents, as well as indicating the cash needs of the entity. The statement of cash flows provides historical information about cash and cash equivalents, classifying cash flows between **operating**, **investing** and **financing** activities.

1.4 Scope

A statement of cash flows should be presented as an integral part of an entity's financial statements. All types of entity can provide useful information about cash flows as the need for cash is universal, whatever the nature of their revenue-producing activities. Therefore all entities are required by the standard to produce a statement of cash flows.

1.5 Benefits of cash flow information

The use of statements of cash flows is very much in conjunction with the rest of the financial statements. Users can gain further appreciation of the change in net assets, of the entity's financial position (liquidity and solvency) and the entity's ability to adapt to changing circumstances by affecting the amount and timing of cash flows. Statements of cash flows enhance comparability as they are not affected by differing accounting policies used for the same type of transactions or events. Cash flow information of a historical nature can be used as an indicator of the amount, timing and certainty of future cash flows. Past forecast cash flow information can be checked for accuracy as actual figures emerge. The relationship between profit and cash flows can be analysed as can changes in prices over time.

1.6 Definitions

The standard gives the following definitions, the most important of which are cash and cash equivalents.

Key terms:

- **Cash** comprises cash on hand and demand deposits.
- **Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
- **Cash flows** are inflows and outflows of cash and cash equivalents.
- **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 non-current assets and other investments not included in cash equivalents.
- **Financing activities** are activities that result in changes in the size and composition of the equity capital and borrowings of the entity.

1.7 Cash and cash equivalents

The standard expands on the definition of cash equivalents: they are not held for investment or other long-term purposes, but rather to meet short-term cash commitments. To fulfill the above definition, an investment's maturity date should normally be within three months from its acquisition date. It would usually be the case then that equity investments (i.e. shares in other companies) are not cash equivalents. An exception would be where preferred shares were acquired with a very close maturity date.

Loans and other borrowings from banks are classified as financing activities. In some countries, however, bank overdrafts are repayable on demand and are treated as part of an entity's total cash management system. In these circumstances an overdrawn balance will be included in cash and cash equivalents. Such banking arrangements are characterized by a balance which fluctuates between overdrawn and credit.

Movements between different types of cash and cash equivalent are not included in cash flows. The investment of surplus cash in cash equivalents is part of cash management, not part of operating, investing or financing activities.

1.8 PRESENTATION OF A STATEMENT OF CASH FLOWS

IAS 7 requires statements of cash flows to report cash flows during the period classified by operating, investing and financing activities.
The manner of presentation of cash flows between operating, investing and financing activities depends on the nature of the entity. By classifying cash flows between different activities in this way users can see the impact on cash and cash equivalent of each one, and their relationships with each other. We can look at each in more detail.

1.8.1 Operating activities

This is perhaps 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 and so on. Most of the components of cash flows from operating activities will be those items which determine the net profit or loss of the entity, i.e. they relate to the main revenue-producing activities of the entity. The standard 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 the 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 investing.

1.8.2 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 capitalized 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 entities.
(d) Cash receipts from sales of shares or debentures of other entities
(e) Cash advances and loans made to other parties
(f) Cash receipts from the repayment of advances and loan made to other parties

1.8.3 Financing activities

This section of the statement of cash flows shows the share of cash which the entity'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 this heading.
(a) Cash proceeds from issuing shares
(b) Cash payments to owners to acquire or redeem the entity's shares
(c) Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other or long-term borrowings
(d) Principal repayments of amounts borrowed under finance leases

NOTE: *Where the reporting entity uses an asset held under a finance lease, the amounts to go in the statement of cash flows as financing activities are repayments of the principal (capital) rather than the interest. The interest paid will be shown under operating activities.*

1.9 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 is the preferred method because it discloses information, not available elsewhere in the financial statements, which could be of use in estimating future cash flows. The example below shows both methods.

1.9.1 Using the direct method

There are different ways in which the information about gross cash receipts and payments can be obtained. The most obvious way is simply to extract the information from the accounting records. This may be a laborious task, however, and the indirect method below may be easier.

1.9.2 Using the indirect method

This method is undoubtedly easier from the point of view of the preparer of the statement of cash flows. The net profit or loss for the period is adjusted for the following.

(a) Changes during the period in inventories, operating receivables and payables

(b) Non-cash items e.g. depreciation, provisions, profits/losses on the sales of assets

(c) Other items, the cash flows from which should be classified under investing or financing activities.

A proforma of such a calculation, taken from the IAS, is as follows;

	Shs.
Cash flows from operating activities	
Profit before taxation	X
Adjustments for:	
Depreciation	X
Foreign exchange loss	X
Investment income	(X)
Interest expense	X
	X
Increase in trade and other receivables	(X)
Decrease in inventories	X
Decrease in trade payables	(X)
Cash generated from operations	X
Interest paid	(X)
Income taxes paid	(X)
Net cash from operating activities	X

It is important to understand why certain items are added and others subtracted. Note the following:
(a) Depreciation is not a cash expense, but is deducted in arriving at profit. It makes sense, therefore, to eliminate it by adding it back.
(b) By the same logic, a loss on a disposal of a non-current asset (arising through under provision of depreciation) needs to be added back and a profit deducted.
(c) An increase in inventories means less cash – you have spent cash on buying inventory.
(d) An increase in receivables means the company's debtors have not paid as much, and therefore there is less cash.
(e) If we pay off payables, causing the figure to decrease, again we have less cash.

(a) Provision for bad debts.

These are just mere book keeping entries and does not involve payment out of cash. When preparing the profit and loss account an increase in the provision for bad debts is included in the expense hence reducing on the profit. Such increase must be added back to the profit. On the other hand, a decrease in the provision for bad debts is taken as an income which is added on the gross profit and hence increasing the net profit of the year yet the cash flow is not affected. Such decrease must be deducted from the operating profit when preparing the cash flow statement.

1.9.3 Indirect versus direct

The direct method is encouraged where the necessary information is not too costly to obtain, but IAS 7 does not require it. In practice the direct method is more commonly used, since it is quicker and easier.

1.10 Interest and dividends

Cash flows from interest and dividends received and paid should each be disclosed separately. Each should be classified in a consistent manner from period to period as either operating, investing or financing activities. Dividends paid by the entity can be classified in one of two ways.

(a) As a financing cash flow, showing the cost of obtaining financial resources

(b) *As a component of cash flows from operating activities so that users can assess the entity's ability to pay dividends out of operating cash flows.*

1.11 Taxes on income

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. Taxation cash flows are often difficult to match to the originating underlying transaction, so most of the time all tax cash flows are classified as arising from operating activities.

1.12 Components of cash and cash equivalents

The components of cash and cash equivalents should be disclosed and a reconciliation should be presented, showing the amounts in the statement of cash flows reconciled with the equivalent items reported in the statement of financial position. It is also necessary to disclose the accounting policy used in deciding the items included in cash and cash equivalents, in accordance with IAS 1 Presentation of financial Statements, but also because of the wide range of cash management practices worldwide.

1.13 Other disclosures

All entities should disclose, together with a commentary by management, any other information likely to be of importance, for example:
(a) Restrictions on the use of or access to any part of cash equivalents
(b) The amount of undrawn borrowing facilities which are available
(c) Cash flows which increased operating capacity compared to cash flows which merely maintained operating capacity

1.14 PREPARING A STATEMENT OF CASH FLOW

You need to be aware of the format of the statement as laid out in IAS 7; setting out the format is an essential first stage in preparing the statement, so this format must be learnt. 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. There is therefore more of it.

1.14.1 PROFOMA CASH FLOW STATEMENTS (Indirect method) – IAS 7

	Shs	Shs
Cash flow from operating activities		
Operating profit/ loss before interest and tax		XX
Adjustment for non-cash items;		
Depreciation charge for the year	XX	
Amortization of intangible and fictitious assets	XX	
Loss / (gain) on disposal	XX/(XX)	XX
		XX
Change in working capital items;		
(Increase) / decrease in inventory	(XX)/XX	
Increase / (decrease) in provision for bad debts	XX/(XX)	
Increase / (decrease) accounts payable / accruals	XX/(XX)	
(Increase) / decrease in accounts receivable	(XX)/XX	
(Increase) / decrease in prepayments	(XX)/XX	
Cash generated from operations		**XX**
Interest paid		(XX)
Income taxes paid		(XX)
Net cash flow from operating activities		**XX**
Cash flow from investing activities		
Acquisition (or purchase) of non-current assets	(XX)	
Proceeds from sale of non-current assets	XX	
Interest received	XX	
Dividends received	XX	
Net cash flows from investing activities		**XX**
Cash flow from financing activities		
Proceeds from issue of shares (including share premium)	XX	
Proceeds from issue of debentures	XX	
Acquisition of long-term debt	XX	
Dividends paid*	(XX)	
Redemption of debentures	(XX)	
Repayment of loan	(XX)	
Net cash flows from financing activities		**XX**
Increase / (Decrease) in cash and cash equivalents		XX/(XX)
Add: Cash and cash equivalents b/d (Note 1)		XX
Cash and cash equivalents c/d (Note 2)		**XX**

∗ This could also be shown as an operating cash flow

NOTES

1. Analysis of cash and cash equivalents
2. When preparing the statement from comparative balance sheets you will usually have to calculate such items as depreciation, loss on sale of asset and profit for the year.
3. Work out the profit if not already given using opening and closing balances of retained earnings, interest expenses, tax charge and dividends.

Retained Earnings A/c: (vertical Format)

	Shs
Closing balances (P & L A/C) / Retained earnings	XX
Add back:	
Dividends (Proposed and paid)	XX
Provision for taxation	XX
Interest expenses	XX
Less:	
Opening balance (P & L a/c) / Retained earnings	(XX)
Profit for the year (PBIT)	**XX**

Where the profit for the year has been given in the statement of changes in equity; then the following adjustments can be made;

	Shs	**Shs**
Profit for the year		XX
Add:		
Taxation	XX	
Interest	XX	XX
		XX
Adjustment for errors in suspense A/c		
Add: - Expenses overstated	XX	
- Income understated	XX	XX
Less: - Expenses understated	XX	
- Income overstated	XX	XX
Profit before income and tax		XX

1.14.2 PROFOMA CASH FLOW STATEMENTS (direct method) – IAS 7

	Shs	**Shs**
Cash flow from operating activities		
Cash receipts from customers	XX	
Cash paid to suppliers	(XX)	
Payment to and on behalf of staff	(XX)	
Payment for operating expenses	(XX)	
Cash flow from operations	XX	
Taxation	(XX)	
Interest paid	(XX)	
Net cash flow from operating activities		**XX**
Cash flow from investing activities		
Acquisition (or purchase) of non-current assets	(XX)	
Proceeds from disposal of non-current assets	XX	
Net cash flows from investing activities		XX

Cash flow from financing activities		
Issue of shares (including share premium)	XX	
Acquisition of long-term debt	XX	
Dividends paid	(XX)	
Redemption of debentures	(XX)	
Repayment of loan	(XX)	
Net cash flows from financing activities		XX
Increase / (Decrease) in cash and cash equivalents		XX/(XX)
Add: Cash and cash equivalents b/d		XX
Cash and cash equivalents c/d		**XX**

In the exam you may have a number of issues to deal with in the statement of cash flows. Examples are:

- **Share capital issues**. The proceeds will be split between share capital and share premium.
- **Bonus issues**. These do not involve cash.
- **Revaluation of non-current assets**. This must be taken into account in calculating acquisitions and disposals.
- **Movement on deferred tax**. This must be taken into account in calculating tax paid.
- **Finance leases**. Assets acquired under finance leases must be adjusted for in non-current asset calculations and the amount paid under the finance lease must appear as a cash flow.
- **Non-current assets** can include amounts for restoration/clean up costs which are not cash flows.

1.14.3 The advantages of cash flow accounting

The advantages of cash flow accounting are as follows.

(a) Survival in business depends on the ability to generate cash. Cash flow accounting directs attention towards this critical issue.

(b) Cash flow is more comprehensive that 'profit' which is dependent on accounting conventions and concepts.

(c) Creditors (long and short-term) are more interested in an entity's ability to repay them than in its profitability. Whereas 'profits' might indicate that cash is likely to be available, cash flow accounting is more direct with its message.

(d) Cash flow reporting provides a better means of comparing the results of different companies than traditional profit reporting.

(e) Cash flow reporting satisfies the needs of all users better.

  (i) For management, it provides the sort of information on which decisions should be taken (in management accounting, relevant costs' to a decision are future cash flows); traditional profit accounting does not help with decision-making.

  (ii) For shareholders and auditors, cash flow accounting can provide a satisfactory basis for stewardship accounting.

  (iii) As described previously, the information needs of creditors and employees will be better served by cash flow accounting.

(f) Cash flow forecasts are easier to prepare, as well as more useful, than profit forecasts.

(g) They can in some respects be audited more easily than accounts based on the accruals concept.

(h) The accruals concept is confusing, and cash flows are more easily understood.

(i) Cash flow accounting should be both retrospective, and also include a forecast for the future. This is of great information value to all users of accounting information.

(j) Forecasts can subsequently be monitored by the publication of variance statements which compare actual cash flows against the forecast.

REVISION QUESTIONS

CPA(U) NOVEMBER 2015

Question 2

(a) IAS 7: Statement of Cash Flows; provides the principles underlying the preparation of a statement of cash flows, which is presented as an integral part of the financial statements.

Required:

(i) Briefly explain the main components of a statement of cash flows, giving at least **two** examples in each case.

(9 marks)

(ii) Explain what is meant by the term 'cash and cash equivalents'.

(1 mark)

(b) The following accounting information was extracted from the financial statements of Berako (U) Ltd for the year ended 31 December, 2014.

Statement of profit or loss and other comprehensive income (extract) for the year ended 31 December:

	2014	2013
	Shs '000'	Shs '000'
Profit before tax	204,000	95,000
Taxation	(52,000)	(32,000)
Profit after tax	152,000	63,000

Statement of financial position as at 31 December:

	2014	2013
Non-current assets:	Shs '000'	Shs '000'
Property, plant and equipment at cost	239,000	176,000
Accumulated depreciation	(107,500)	(95,000)
	131,500	81,000
Current assets:		
Inventory	90,000	20,000
Accounts receivable	167,600	86,000
Prepaid expenses	4,000	3,000
Interest receivable	400	300
Cash at bank	--	7,100
	262,000	116,400
Total assets	393,500	197,400

	2014	2013
Equity and liabilities:	Shs '000'	Shs '000'
Equity:		
Ordinary share capital Shs 1 per share	50,000	50,000
10% preference share capital Shs 1 per share	10,000	10,000
Retained earnings	101,000	30,000
	161,000	90,000
Liabilities:		
Non-current liabilities:		
15% loan	7,500	6,000
Current liabilities:		
Accounts payable	100,000	60,000
Accruals	10,000	8,000
Interest payable	800	1,400
Taxation	52,000	32,000
Bank overdraft	62,200	--
	225,000	101,400
Total equity and liabilities	393,500	197,400

Additional information:

1 Dividends paid for the year ending 31 December:

	2014	2013
	Shs '000'	Shs '000'
Preference	1,000	1,000
Ordinary	80,000	40,000
	81,000	41,000

2 During the year to 31 December, 2014 non-current assets originally costing Shs 55 million were disposed of for Shs 10 million. The accumulated depreciation on the assets disposed of as at 31 December, 2013 was Shs 38 million. It is company policy to charge full depreciation in the year of acquisition and none in the year of disposal.

3 Interest income of Shs 500,000 and interest expense of Shs 1,125,000 were recognised in profit or loss in determining the profit before tax for the year to 31 December, 2014.

Required

Prepare a statement of cash flows for the year ended 31 December, 2014 as per IAS 7, using the indirect method. **(20 marks)**

(Total 30 marks)