6 Statement of cash flows

this chapter covers...

In this chapter we study the statement of cash flows, which links profit from the statement of profit or loss and other comprehensive income with changes in assets and liabilities in the statement of financial position, and the effect on the cash of the company. We will cover:

- *an appreciation of the need for a statement of cash flows*
- *the cash flows for the sections of the statement*
- *how the cash flows relate to the areas of business activity*
- *the interpretation of a statement of cash flows*

The international financial reporting standard that sets out the layouts and gives detailed guidance on the preparation of statements of cash flows is IAS 7.

There are two ways of setting out statements of cash flows: the direct method and the indirect method. The main part of the chapter focuses on the indirect method and then, on page 175, we see how the direct method is used and we note that it is only the first section of the statement of cash flows that varies between the two methods. (Note that AAT's Assessment for Financial Statements requires the statement of cash flows to be drafted using only the indirect method. For the direct method, a knowledge of examples of cash flows from operating activities – see page 175 – is required.)

INTRODUCTION

The statement of profit or loss and other comprehensive income shows profitability, and the statement of financial position shows asset strength. While these two financial statements give us a great deal of information on the progress of a company during an accounting period, profit does not equal cash, and strength in assets does not necessarily mean a large bank balance.

The **statement of cash flows** links profit with changes in assets and liabilities, and the effect on the cash of the company.

> *A statement of cash flows uses information from the accounting records (including statements of profit or loss and other comprehensive income and financial position) to show an overall view of money flowing in and out of a company during an accounting period.*

Such a statement explains to the shareholders why, after a year of good profits for example, there is a reduced balance at the bank or a larger bank overdraft at the year-end than there was at the beginning of the year. The statement of cash flows concentrates on the liquidity of the business: it is often a lack of cash (a lack of liquidity) that causes most businesses to fail.

Such is the importance of cash flows that companies preparing and presenting accounts in accordance with international financial reporting standards are required to include a statement of cash flows as an integral part of their financial statements.

FORMAT OF THE STATEMENT OF CASH FLOWS

IAS 7, *Statement of Cash Flows*, provides the guidelines for a format, divided into three sections:

- **Operating activities** – the main revenue-producing activities of the business, together with the payment of interest and tax
- **Investing activities** – the acquisition and disposal of non-current assets, and other investments, together with interest and dividends received
- **Financing activities** – receipts from the issue of new shares, payments to repay shares, changes in long-term borrowings, payment of dividends

The cash flows for the year affecting each of these three areas of business activity are shown in the statement.

At the bottom of the statement of cash flows is shown the net increase in cash and cash equivalents for the period, together with the cash and cash equivalents, both at the beginning and at the end of the period.

Note the following terms:

- **cash**, which comprises cash on hand and demand deposits
- **cash equivalents**, which are short-term, highly liquid investments that can easily be converted into cash (an example of a cash equivalent is money held in a term account, provided that the money can be withdrawn within three months from the date of deposit)

Bank overdrafts which are payable on demand are included as a part of cash and cash equivalents.

The diagram on the next page shows the main cash flows (inflows and outflows of cash and cash equivalents) under each heading, and indicates the content of the statement of cash flows. The first section – operating activities – needs a word of further explanation, particularly as it is the main source of cash flow for most companies.

operating activities (indirect method)

The cash flow from operating activities is calculated by using figures from the statements of profit or loss and other comprehensive income and financial position as follows:

	profit from operations* (profit, before deduction of tax & interest)
add	depreciation charge for the year
add	loss on sale of non-current assets, or *deduct* gain on sale of non-current assets – see page 166
deduct	dividends received (shown in investing activities)
add	decrease in inventories, or *deduct* increase in inventories
add	decrease in trade and other receivables, or *deduct* increase in trade and other receivables
add	increase in trade and other payables, or *deduct* decrease in trade and other payables
equals	**cash used in/from operations**
deduct	interest paid in period
deduct	tax paid on income in period (eg corporation tax)
equals	**net cash used in/from operating activities**

* 'Profit from operations' is always the starting point in AAT Assessments where a task requires you to reconcile profit or loss to the net cash from operating activities. An example of such a reconciliation is shown on page 162.

Notes:

- Depreciation is added to profit because depreciation is a non-cash expense, that is, no money is paid out by the company in respect of depreciation charged to the statement of profit or loss and other comprehensive income.
- Cash flows relating to the purchase and sale of non-current assets are shown in the investing activities section.

- The dividends received deducted here will be added in the investing activities section.
- The operating activities section is calculated differently for the direct method – see page 175.

LAYOUT OF A STATEMENT OF CASH FLOWS

A statement of cash flows uses a common layout which can be amended to suit the particular needs of the company for which it is being prepared. The example layout shown on page 162 (with specimen figures included) is commonly used. It is suggested that you study a recent statement of cash flows for a large public limited company – the web directory at the beginning of this book lists some sources.

The diagram below shows the contents of a statement of cash flows using the indirect method. Note that the direct method is discussed on page 175 where we will see that it is only the operating activities section which is set out in a different way.

statement of cash flows (indirect method)

Operating activities

- Profit from operations (ie profit, before deduction of tax and interest)
- Depreciation charge for the year (see page 166 for treatment of a gain or a loss on sale of non-current assets)
- Less dividends received (shown in investing activities)
- Changes in inventories, trade and other receivables and payables
- Less interest paid
- Less taxes paid on income (eg corporation tax)

Investing activities

- Inflows: sale proceeds from property, plant and equipment, intangibles, and other non-current assets
- Outflows: purchase cost of property, plant and equipment, intangibles, and other non-current assets
- Interest received
- Dividends received

Financing activities

- Inflows: receipts from increase in share capital (note: no cash inflow from a bonus issue of shares – see page 69), raising/increase of loans
- Outflows: repayment of share capital/loans, and finance lease liabilities
- Dividends paid

STATEMENT OF CASH FLOWS: INDIRECT METHOD

ABC LIMITED
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20-6

	£	£
Net cash used in/from operating activities		78,000
Cash flows from investing activities		
Purchase of non-current assets	–125,000	
Proceeds from sale of non-current assets	15,000	
Interest received	10,000	
Dividends received	–	
Net cash used in/from investing activities		–100,000
Cash flows from financing activities		
Proceeds from issue of share capital	275,000	
Repayment of share capital	–	
Proceeds from long-term borrowings	–	
Repayment of long-term borrowings	–140,000	
Dividends paid (note: amount paid during year)	–22,000	
Net cash used in/from financing activities		113,000
Net increase/decrease in cash and cash equivalents		91,000
Cash and cash equivalents at beginning of year		105,000
Cash and cash equivalents at end of year		196,000

RECONCILIATION OF PROFIT FROM OPERATIONS TO NET CASH FROM OPERATING ACTIVITIES

	£
Profit from operations (note: before tax and interest)	75,000
Adjustments for:	
Depreciation for year	10,000
Decrease in inventories	2,000
Increase in trade and other receivables	–5,000
Increase in trade and other payables	7,000
Cash used in/from operations	89,000
Interest paid (note: amount paid during year)	–5,000
Income taxes paid (note: amount paid during year)	–6,000
Net cash used in/from operating activities	78,000

notes on the layout of a statement of cash flows

- The separate amounts shown for each section can, if preferred, be detailed in a note to the statement of cash flows. The operating activities section is invariably set out in detail as a note below the statement of cash flows, with just the figure for net cash from operating activities (see example opposite) being shown on the statement – see grey line.
- Money amounts shown in brackets (or a minus sign) indicate a deduction or, where the figure is a sub-total, a negative figure.
- The changes in the main working capital items of inventories, trade and other receivables, and trade and other payables have an effect on cash balances. For example, a decrease in inventory increases cash, while an increase in trade receivables reduces cash.
- IAS 7 allows some flexibility in the way in which companies present their statements of cash flows. In particular, the cash flows from interest and dividends received and paid can be classified as operating or investing or financing activities – in AAT Assessments interest received and dividends received are always treated as investing activities (note that for AAT, interest paid is shown as an operating activity, and dividends paid is shown as a financing activity).
- Cash flows arising from taxes on income – eg corporation tax – are always classified as operating activities, unless they can be specifically identified with financing and investing activities.
- The statement of cash flows concludes with a figure for the net increase or decrease in cash and cash equivalents for the year. This is calculated from the subtotals of each of the three sections of the statement. Added to this is the amount of cash and cash equivalents at the beginning of the year. Thus the final figure of the statement is that of cash and cash equivalents at the end of the year.

Case Study

STATEMENT OF CASH FLOWS

situation

The statements of financial position of Newtown Trading Company Limited for 20-5 and 20-6 are shown on the next page.

Prepare a statement of cash flows for the year ended 31 December 20-6 and comment on the main points highlighted by the statement. Note the following points:

- Extract from the statement of profit or loss and other comprehensive income for 20-6:

	£
Profit from operations	9,400
Interest paid	–400
Profit before tax	9,000
Tax	–1,500
Profit for the year	7,500

- Dividends of £1,500 were paid in 20-5, and £2,000 in 20-6.
- During 20-6 the property was revalued at £125,000.

Tutorial note:
When preparing a statement of cash flows from financial statements, take a moment or two to establish which is the earlier year and which is the later year. In this Case Study they are set out from left to right, ie 20-5 followed by 20-6. In some Assessments, the later year is shown first, ie 20-6 followed by 20-5.

NEWTOWN TRADING COMPANY LIMITED

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER

	20-5			20-6		
	£	£	£	£	£	£
ASSETS	**Cost**	**Dep'n**	**Net**	**Cost or reval'n**	**Dep'n**	**Net**
Non-current assets						
Property	75,000	-	75,000	125,000	-	125,000
Plant and equipment	22,200	6,200	16,000	39,000	8,900	30,100
	97,200	6,200	91,000	164,000	8,900	155,100
Current assets						
Inventories			7,000			11,000
Trade and other receivables			5,000			3,700
Cash and cash equivalents			1,000			500
			13,000			15,200
Total assets			104,000			170,300
EQUITY AND LIABILITIES						
Equity						
Share capital			80,000			90,000
Share premium			1,500			2,500
Revaluation reserve			–			50,000
Retained earnings			11,000			16,500
Total equity			92,500			159,000
Non-current liabilities						
Debentures			5,000			3,000
Current liabilities						
Trade and other payables			5,500			6,800
Tax liabilities			1,000			1,500
			6,500			8,300
Total liabilities			11,500			11,300
Total equity and liabilities			104,000			170,300

solution

NEWTOWN TRADING COMPANY LIMITED
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20-6

	£	£
Net cash used in/from operating activities (see below)		9,300
Cash flows from investing activities		
Purchase of non-current assets (plant and equipment)	–16,800	
Net cash used in/from investing activities		–16,800
Cash flows from financing activities		
Issue of ordinary shares at a premium		
ie £10,000 + £1,000 =	11,000	
Repayment of debentures	–2,000	
Dividends paid	–2,000	
Net cash used in/from financing activities		7,000
Net increase/decrease in cash and cash equivalents		–500
Cash and cash equivalents at beginning of year		1,000
Cash and cash equivalents at end of year		500

RECONCILIATION OF PROFIT FROM OPERATIONS TO NET CASH FROM OPERATING ACTIVITIES

	£
Profit from operations (before tax and interest)	9,400
Adjustments for:	
Depreciation for year*	2,700
Increase in inventories	–4,000
Decrease in trade and other receivables	1,300
Increase in trade and other payables	1,300
Cash used in/from operations	10,700
Interest paid	–400
Income taxes paid	–1,000
Net cash used in/from operating activities	9,300

* Depreciation charged: £8,900 – £6,200 = £2,700

notes on the statement of cash flows

The liability for tax – which is a current liability at 31 December 20-5 – is paid in 20-6. Likewise, the current liability for tax at 31 December 20-6 will be paid in 20-7 (and will appear on that year's statement of cash flows).

The dividend is the amount **paid** during 20-6, ie £2,000.

The revaluation of the property (increase in the value of the non-current asset, and revaluation reserve recorded in the equity section) does not feature in the statement of cash flows because it is a non-cash transaction. Remember that the amount of the revaluation will also be shown as other comprehensive income in the statement of profit or loss and other comprehensive income.

how useful is the statement of cash flows?

The following points are highlighted by the statement on the previous page:

- cash generated from operations is £10,700 (this is before interest and tax is paid for the year)
- net cash from operating activities is £9,300
- a purchase of plant and equipment of £16,800 has been made, financed partly by operating activities, and partly by an issue of shares at a premium
- the bank balance during the year has fallen by £500, ie from £1,000 to £500

In conclusion, the picture shown by the statement of cash flows is that of a business which is generating cash from its operating activities and using the cash to build for the future.

GAIN OR LOSS ON DISPOSAL OF NON-CURRENT ASSETS

carrying amount and sale proceeds

When a company disposes of non-current assets it is most unlikely that the resultant sale proceeds will be equal to the carrying amount (cost/revaluation less accumulated depreciation) – there will be a gain or loss on disposal.

dealing with a gain or loss on disposal

The accounting solution is to transfer any small gain or loss on disposal – non-cash items – to the statement of profit or loss and other comprehensive income. However, such a gain or loss on disposal must be handled with care when preparing a statement of cash flows because, in such a statement we have to adjust for non-cash items when calculating the net cash from operating activities; at the same time we must separately identify the amount of the proceeds of sale of non-current assets in the investing activities section.

Case Study

GAIN OR LOSS ON DISPOSAL OF NON-CURRENT ASSETS

situation

H & J Wells Limited is an electrical contractor. For the year ended 30 June 20-6 its statement of profit or loss and other comprehensive income is as follows:

			£	£
Gross profit				37,500
Expenses:				
	General expenses		–23,000	
	Provision for depreciation:	plant	–2,000	
		equipment	–3,000	
				–28,000
Profit from operations				9,500

gain on disposal

During the course of the year the company has sold the following non-current asset; the effects of the disposal transaction have not yet been recorded in the statement of profit or loss and other comprehensive income:

		£
Plant:	cost price	1,000
	depreciation to date	–750
	carrying amount	250
	proceeds of sale	350

As the plant has been sold for £100 more than the carrying amount, this gain on disposal is shown in the statement of profit or loss and other comprehensive income, as follows:

			£	£
Gross profit				37,500
Gain on disposal of non-current assets				100
				37,600
Expenses:				
	General expenses		–23,000	
	Provision for depreciation:	plant	–2,000	
		equipment	–3,000	
				–28,000
Profit from operations				9,600

The statement of cash flows, based on the amended statement of profit or loss and other comprehensive income, will include the following figures:

STATEMENT OF CASH FLOWS (EXTRACT) OF H & J WELLS LIMITED FOR THE YEAR ENDED 30 JUNE 20-6

	£	£
Cash flows from operating activities		
Profit from operations	9,600	
Adjustments for:		
Depreciation for year	5,000	
Gain on disposal of non-current assets	–100	
Increase/decrease in inventories	. . .	
Increase/decrease in trade and other receivables	. . .	
Increase/decrease in trade and other payables	. . .	
Net cash used in/from operating activities		14,500
Cash flows from investing activities		
Purchase of non-current assets	–. . .	
Proceeds from disposal of non-current assets	350	
Net cash used in/from investing activities		350

Note that the gain on disposal of non-current assets is deducted in the operating activities section because it is non-cash income. (Only the sections of the statement of cash flows affected by the disposal are shown above.)

loss on disposal

If the plant in the Case Study had been sold for £150, this would have given a loss on disposal of £100. This amount would be debited to the statement of profit or loss and other comprehensive income, to give an amended profit from operations of £9,400. The effect on the statement of cash flows would be twofold:

1 In the operating activities section, loss on disposal of non-current assets of £100 would be added; the net cash from operating activities remains at £14,500 (which proves that both gain and loss on disposal of non-current assets are items which do not affect cash)

2 In the investing activities section, proceeds from disposal of non-current assets would be £150

conclusion: disposal of non-current assets

The rule for dealing with a gain or a loss on disposal of non-current assets in a statement of cash flows is:

- add the amount of the loss on disposal, or deduct the amount of the gain on disposal, to or from the profit from operations when calculating the net cash from operating activities

- show the total disposal proceeds, ie the amount of the payment received, as proceeds from sale of non-current assets in the investing activities section

The Case Study below incorporates calculations for a gain on disposal of non-current assets.

REVALUATION OF NON-CURRENT ASSETS

From time-to-time some non-current assets are revalued upwards and the amount of the revaluation is recorded as other comprehensive income and is taken to the statement of financial position. The most common asset to be treated in this way is property. The value of the non-current asset is increased and the amount of the revaluation is placed to a revaluation surplus in the equity section of the statement of financial position where it increases the total equity of the company. As a revaluation is purely a 'book' adjustment, ie no cash has changed hands, it does not feature in a statement of cash flows – see the Case Study of Newtown Trading Company Limited on pages 163 to 166.

PREPARING FOR ASSESSMENT

In AAT Assessments there are two tasks which require financial statements to be drafted. In Chapter 3 we have already seen (page 72) the two tasks for preparing statements of profit or loss, changes in equity, and financial position. The alternative two tasks in assessments focus on the statement of cash flows. Here you will be provided with a statement of profit or loss and other comprehensive income for a single year and statements of financial position for two years:

- in the first task you will be required to prepare a reconciliation of profit from operations to net cash from operating activities and a statement of cash flows
- in the second task you will be required to draft a statement of changes in equity (see page 174)

Both of these tasks use the same statements of profit or loss and other comprehensive income and financial position. Blank layouts are provided and, in the AAT Assessment, you select narrative items from pick lists and enter money amounts into gap fill boxes. Pro-formas for workings are also provided, as appropriate, in the assessment and partial marks can be obtained from these in the event of errors being made in the main layouts for the statements. Note that pro-formas for layouts and workings – in the format used in AAT Assessments – are provided in the Appendix of this book.

In the Case Study which follows we see how the aspects of the statement of cash flows and the statement of changes in equity are prepared from the statements of profit or loss and other comprehensive income and financial position – ie the two tasks for this type of AAT Assessment.

Case Study

STATEMENT OF CASH FLOWS

situation

You have been asked to prepare the statement of cash flows and changes in equity for Doddington Ltd for the year ended 31 December 20X6.

The most recent statement of profit or loss and statement of financial position (with comparatives for the previous year) of Doddington Ltd are set out below.

Doddington Ltd
Statement of profit or loss for the year ended 31 December 20X6

Continuing operations	*£000*
Revenue	755
Cost of sales	–546
Gross profit	209
Dividends received	6
Gain on disposal of property, plant and equipment	10
Distribution costs	–115
Administrative expenses	–79
Profit from operations	31
Finance costs	–3
Profit before tax	28
Tax	–7
Profit for the period from continuing operations	21

Doddington Ltd
Statement of financial position as at 31 December 20X6

	20X6	20X5
	£000	*£000*
ASSETS		
Non-current assets		
Property, plant and equipment	275	200
Current assets		
Inventories	74	50
Trade receivables	120	80
Cash and cash equivalents	0	10
	194	140
Total assets	469	340
EQUITY AND LIABILITIES		
Equity		
Share capital	220	200
Share premium	10	0
Retained earnings	70	64
Total equity	300	264
Non-current liabilities		
Bank loans	60	0
	60	0
Current liabilities		
Trade payables	87	72
Tax liabilities	7	4
Bank overdraft	15	0
	109	76
Total liabilities	169	76
Total equity and liabilities	469	340

Further information:

- The total depreciation charge for the year was £36,000.
- Property, plant and equipment costing £40,000 with accumulated depreciation of £20,000 was sold in the year.
- All sales and purchases were on credit. Other expenses were paid for in cash.
- A dividend of £15,000 was paid during the year.

required

(a) Prepare a reconciliation of profit from operations to net cash from operating activities for Doddington Ltd for the year ended 31 December 20X6.

(b) Prepare the statement of cash flows for Doddington Ltd for the year ended 31 December 20X6.

(c) Draft the statement of changes in equity for Doddington Ltd for the year ended 31 December 20X6.

solution

(a) Doddington Ltd

Reconciliation of profit from operations to net cash from operating activities

	£000
Profit from operations	31
Adjustments for:	
Depreciation	36
Dividends received	–6
Gain on disposal of property, plant and equipment	–10
Adjustment in respect of inventories	–24
Adjustment in respect of trade receivables	–40
Adjustment in respect of trade payables	15
Cash generated by operations	2
Tax paid	–4
Interest paid	–3
Net cash from operating activities	–5

Tutorial note for AAT Assessments:

- 'profit from operations' is always the starting point for tasks which require the preparation of this reconciliation
- dividends received are always treated as investing activities – therefore they are deducted in the calculation of cash generated by operations

(b) Doddington Ltd

Statement of cash flows for the year ended 31 December 20X6	
	£000
Net cash from operating activities	–5
Investing activities	
Dividends received	6
Proceeds on disposal of property, plant and equipment	30
Purchases of property, plant and equipment	–131
Net cash used in investing activities	–95
Financing activities	
Bank loans raised	60
Proceeds of share issue	30
Dividends paid	–15
Net cash from financing activities	75
Net increase/decrease in cash and cash equivalents	–25
Cash and cash equivalents at beginning of year	10
Cash and cash equivalents at end of year	–15

Workings

Proceeds on disposal of property, plant and equipment	*£000*
Carrying amount of property, plant and equipment sold	20
Gain on disposal	10
Proceeds =	30

Purchases of property, plant and equipment	*£000*
Property, plant and equipment at start of year	200
Depreciation charge	–36
Carrying amount of property, plant and equipment sold	–20
Property, plant and equipment at end of year	–275
Total property, plant and equipment additions =	–131

(c) Doddington Ltd

Statement of changes in equity for the year ended 31 December 20X6

	Share capital	Share premium	Retained earnings	Total equity
	£000	*£000*	*£000*	*£000*
Balance at 1 January 20X5	200	0	64	264
Changes in equity for 20X6				
Profit for the period			21	21
Dividends			–15	–15
Issue of share capital	20	10		30
Balance at 31 December 20X6	220	10	70	300

how useful is the statement of cash flows?

While the type of AAT Assessment task considered here will not ask you to comment on the statement of cash flows, aspects of cash flows can feature in tasks which require the interpretation of financial statements (see Chapter 7).

The following points are highlighted by the statement of cash flows of Doddington Ltd for the year ended 31 December 20X6:

- although there is a reasonable profit from operations of £31,000, the cash generated from operations is just £2,000 – insufficient to cover the tax and interest paid
- inventories, trade receivables and trade payables have increased – in particular trade receivables – so that a net £49,000 of cash has been used
- non-current assets of £131,000 have been purchased which have been almost financed by the £120,000 from the sale of non-current assets, the bank loan raised, and the proceeds of the share issue
- with a net decrease of £25,000 in cash and cash equivalents during the year, it might have been prudent to pay a smaller dividend

The company appears to be expanding, with increases in non-current assets, current assets and current liabilities. Despite the share issue and the loan raised, quite a lot of the expansion has been financed through the bank. It might have been better to have obtained more long-term finance rather than using a bank overdraft.

STATEMENT OF CASH FLOWS: THE DIRECT METHOD

So far in this chapter we have focussed on preparing the statement of cash flows using the **indirect method**. Thus the operating activities section starts with the profit from operations. As an alternative, IAS 7 allows the **direct method**. For the operating activities section this method, instead of starting with profit, shows cash flows as follows:

- cash received from the sale of goods
- cash paid to suppliers and employees
- interest paid
- tax paid

As an example of the direct method we will use the statement of cash flows of ABC Limited shown on page 162. The cash (used in)/from operations is calculated in the following way (with specimen figures included):

Cash flows from operating activities	£
Cash received from the sale of goods	759,000
Cash paid to suppliers and employees	–670,000
Cash used in/from operations	89,000
Interest paid	–5,000
Tax paid	–6,000
Net cash (used in)/from operating activities	78,000

Note that the figure of £89,000 for cash from operations and the £78,000 net cash from operating activities are the same as the indirect method on page 162. The statement of cash flows presented using the direct method is shown on the next page.

To summarise the direct method:

- only the operating activities section is set out differently from the indirect method
- cash receipts and cash payments are shown in the calculation of cash (used in)/from operations

Note that AAT's Assessment requires you to have knowledge of the examples of cash flows to be classified as operating activities when using the direct method.

STATEMENT OF CASH FLOWS: DIRECT METHOD

ABC LIMITED

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20-6

	£	£
Net cash used in/from operating activities		78,000
Cash flows from investing activities		
Purchase of non-current assets	–125,000	
Proceeds from sale of non-current assets	15,000	
Interest received	10,000	
Dividends received	–	
Net cash used in/from investing activities		–100,000
Cash flows from financing activities		
Proceeds from issue of share capital	275,000	
Repayment of share capital	–	
Proceeds from long-term borrowings	–	
Repayment of long-term borrowings	–140,000	
Dividends paid (note: amount paid during year)	–22,000	
Net cash used in/from financing activities		113,000
Net increase/decrease in cash and cash equivalents		91,000
Cash and cash equivalents at beginning of year		105,000
Cash and cash equivalents at end of year		196,000

Calculation of cash from operating activities	£
Cash flows from operating activities	
Cash received from the sale of goods	759,000
Cash paid to suppliers and employees	–670,000
Cash used in/from operations	89,000
Interest paid	–5,000
Tax paid	–6,000
Net cash used in/from operating activities	78,000

LINKS TO THE STATEMENT OF FINANCIAL POSITION

As the statement of cash flows is one of the main financial statements prepared at the end of an accounting period, it needs to be read in conjunction with the statement of financial position. In order to help the user of the statement of cash flows, IAS 7 requires that there should be explanatory notes on cash and cash equivalents.

cash and cash equivalents

Companies must disclose the components of cash and cash equivalents and reconcile the amounts shown in the statement of cash flows with the figures from the statement of financial position. Thus, for ABC Limited (see previous page) the reconciliation could be shown as follows, with specimen figures used:

Reconciliation of cash and cash equivalents

	31 December 20-5	**31 December 20-6**
	£	£
Cash	20,000	26,000
Overdraft	–45,000	–20,000
Short-term deposits	130,000	190,000
Cash and cash equivalents	105,000	196,000

INTERPRETING THE STATEMENT OF CASH FLOWS

The statement of cash flows is important because it identifies the sources of cash flowing into the company and shows how they have been used. To get an overall view of the company, we need to read the statement in conjunction with the other main financial statements – profit or loss and other comprehensive income and financial position – and also in the context of the previous year's statements.

The following points should be borne in mind:

- Like the other financial statements, the statement of cash flows uses the money measurement concept. This means that only items which can be recorded in money terms can be included; also we must be aware of the effect of inflation if comparing one year with the next.

- Look for positive cash flows from the operating activities section. In particular, look at the subtotal 'cash (used in)/from operations' – this shows the cash from revenue-producing activities before the payment of interest and tax.

- Make a comparison between the amount of profit and the amount of cash generated from operations. Identify the reasons for major differences between these figures – look at the changes in inventories, trade and other receivables, and trade and other payables, and put them into context. For example, it would be a warning sign if there were large increases in these items in a company with falling profits, and such a trend would put a strain on the liquidity of the business. Also consider the company's policies on collecting trade receivables and potential for bad (irrecoverable) debts, payment to trade payables (is the company paying too quickly?) and control of inventories (are surpluses building up?).

- Look at the figure for 'net cash (used in)/from operating activities', ie the cash from operations after interest and tax have been paid. If it is a positive figure, it shows that the company has been able to meet its interest and tax obligations to loan providers and the tax authorities.

- The investing activities section of the statement shows the amount of investment made during the year (eg the purchase of non-current assets). In general there should be a link between the cost of the investment and an increase in loans and/or share capital – it isn't usual to finance non-current assets from short-term sources, such as a bank overdraft.

- In the financing activities section of the statement, where there has been an increase in loans and/or share capital, look to see how the money has been used. Was it to buy non-current assets or other investments, or to finance inventory and trade receivables, or other purposes?

- Look at the amount of dividends paid – this is an outflow of cash that will directly affect the change in the bank balance. As a quick test, the amount of net cash from operating activities should, in theory, be sufficient to cover dividends paid; if it doesn't, then it is likely that the level of dividends will have to be reduced in future years.

- The statement of cash flows, as a whole, links profit with changes in cash. Both of these are important: without profits the company cannot generate cash (unless it sells non-current assets), and without cash it cannot pay bills as they fall due.

Chapter Summary

- The objective of a statement of cash flows is to show an overall view of money flowing in and out of a company during an accounting period.
- IAS 7 is the international financial reporting standard that sets out the requirements of statements of cash flows.
- A statement of cash flows is divided into three sections:
  1. operating activities – the main revenue-producing activities of the business, together with the payment of interest and tax
  2. investing activities – the acquisition and disposal of non-current assets, and some other investments
  3. financing activities – receipts from the issue of new shares, payments to cover the repayment of shares, changes in long-term borrowings
- There are two methods of setting out the operating activities section: the direct method and the indirect method.
- Limited companies are required to include a statement of cash flows as a part of their financial statements.

Key Terms

statement of cash flows	shows an overall view of money flowing in and out of a company during an accounting period using either the direct method or the indirect method
cash from operations	profit from operations (ie before deduction of tax and interest), add depreciation for the year, add loss (or deduct gain) on disposal of non-current assets, deduct investment income, together with changes in inventories, trade and other receivables, and trade and other payables
net cash from operating activities	cash generated from operations (see above), deduct interest paid in period, deduct taxes paid on income in period
investing activities	cost of purchase and/or proceeds of disposal of non-current assets; dividends received; interest received
financing activities	issue or repayment of share capital and/or long-term borrowings; dividends paid
cash	cash on hand and demand deposits
cash equivalents	short-term, highly liquid investments that can easily be converted into cash

Activities

- A blank photocopiable pro-forma in the format used in AAT Assessments – of the statement of cash flows is included in the Appendix – it is advisable to enlarge it to full A4 size. Blank workings sheets are also included in the Appendix.
- Pro-formas and workings sheets are also available to download from www.osbornebooks.co.uk

6.1 An increase in inventories will have a negative impact on cash flow in the calculation of net cash flow from operating activities.

True / False

6.2 A gain on disposal of property, plant and equipment will have a negative impact on cash flow in the calculation of net cash flow from operating activities.

True / False

6.3 A decrease in trade payables will have a positive impact on cash flow in the calculation of net cash flow from operating activities.

True / False

6.4 An increase in trade receivables will have a positive impact on cash flow in the calculation of net cash flow from operating activities.

True / False

6.5 A loss on disposal of property, plant and equipment will have a positive impact on cash flow in the calculation of net cash flow from operating activities.

True / False

6.6 A cash receipt from the sale of property, plant and equipment will be classified as an investing activity in the statement of cash flows.

True / False

6.7 When preparing a statement of cash flows using the direct method, which of the following cash flows are used?

1. cash paid to suppliers and employees
2. cash received from the sale of goods
3. tax paid
4. interest paid

	✓
(a) 1 and 2	
(b) 1, 2 and 3	
(c) 3 and 4	
(d) all of them	

6.8 The following information relates to a company for the year ended 30 June 20X1.

Profit from operations (after deducting depreciation of £5,000) is £12,400

	At 30.6.20X1	**At 30.6.20X0**
	£	£
Inventories	3,600	3,900
Trade receivables	4,800	4,200
Trade payables	4,100	3,700

What is the net cash generated from operating activities (prior to any tax and interest paid)?

	✓
(a) £17,500	
(b) £17,400	
(c) £18,700	
(d) £12,500	

6.9 Dewa Ltd has a profit from operations of £25,000 for 20X1. The company's statement of profit or loss and other comprehensive income and statement of financial position show the following:

	£
depreciation charge	8,000
decrease in inventories	3,000
increase in trade and other receivables	5,000
increase in trade and other payables	2,000

What is the cash from operations for 20X1?

	✓
(a) £33,000 inflow	
(b) £37,000 inflow	
(c) £13,000 inflow	
(d) £43,000 inflow	

6.10 Sumner Ltd has a loss from operations of £8,000 for 20X2. The company's statement of profit or loss and other comprehensive income and statement of financial position show the following:

	£
depreciation charge	7,500
increase in inventories	2,500
increase in trade and other receivables	1,500
decrease in trade and other payables	1,000

What is the cash from operations for 20X2?

	✓
(a) £4,500 inflow	
(b) £2,500 outflow	
(c) £5,500 outflow	
(d) £4,500 outflow	

6.11 Zhang Ltd has a profit from operations of £12,500 for 20X3. The company's statement of profit or loss and other comprehensive income and statement of financial position show the following:

	£
depreciation charge	8,500
gain on disposal of property, plant and equipment	3,500
decrease in inventories	2,500
increase in trade and other receivables	3,000
decrease in trade and other payables	2,000

What is the cash from operations for 20X3?

		✓
(a)	£26,000 inflow	
(b)	£15,000 inflow	
(c)	£16,000 inflow	
(d)	£32,000 inflow	

6.12 You have been asked to prepare the statement of cash flows for Minster Ltd for the year ended 31 March 20X1.

The most recent statement of profit or loss and statement of financial position (with comparatives for the previous year) of Minster Ltd are set out below.

Minster Ltd – Statement of profit or loss for the year ended 31 March 20X1

Continuing operations	*£000*
Revenue	2,749
Cost of sales	–1,312
Gross profit	1,437
Dividends received	25
Gain on disposal of property, plant and equipment	53
Distribution costs	–624
Administrative expenses	–347
Profit from operations	544
Finance costs	–54
Profit before tax	490
Tax	–115
Profit for the year from continuing operations	375

Minster Ltd – Statement of financial position as at 31 March 20X1

	20X1	20X0
	£000	*£000*
ASSETS		
Non-current assets		
Property, plant and equipment	3,640	2,490
Current assets		
Inventories	145	138
Trade receivables	185	196
Cash and cash equivalents	133	0
	463	334
Total assets	4,103	2,824
EQUITY AND LIABILITIES		
Equity		
Share capital	1,500	1,000
Share premium	750	500
Retained earnings	582	432
Total equity	2,832	1,932
Non-current liabilities		
Bank loans	1,000	600
	1,000	600
Current liabilities		
Trade payables	156	145
Tax liabilities	115	107
Bank overdraft	0	40
	271	292
Total liabilities	1,271	892
Total equity and liabilities	4,103	2,824

Further information:

- The total depreciation charge for the year was £365,000.
- Property, plant and equipment costing £260,000 with accumulated depreciation of £95,000 was sold in the year.
- All sales and purchases were on credit. Other expenses were paid for in cash.
- A dividend of £225,000 was paid during the year.

Required:

(a) Prepare a reconciliation of profit from operations to net cash from operating activities for Minster Ltd for the year ended 31 March 20X1.

(b) Prepare the statement of cash flows for Minster Ltd for the year ended 31 March 20X1.

6.13 You have been asked to prepare the statement of cash flows and changes in equity for Velani Ltd for the year ended 31 March 20X2.

The most recent statement of profit or loss and statement of financial position (with comparatives for the previous year) of Velani Ltd are set out below.

Velani Ltd – Statement of profit or loss for the year ended 31 March 20X2

Continuing operations	*£000*
Revenue	53,600
Cost of sales	–36,420
Gross profit	17,180
Dividends received	45
Loss on disposal of property, plant and equipment	–110
Distribution costs	–11,163
Administrative expenses	–4,032
Profit from operations	1,920
Finance costs	–109
Profit before tax	1,811
Tax	–347
Profit for the year from continuing operations	1,464

Velani Ltd – Statement of financial position as at 31 March 20X2

	20X2	20X1
	£000	*£000*
ASSETS		
Non-current assets		
Property, plant and equipment	12,832	9,911
Current assets		
Inventories	5,057	5,168
Trade receivables	5,341	4,730
Cash and cash equivalents	0	1,360
	10,398	11,258
Total assets	23,230	21,169
EQUITY AND LIABILITIES		
Equity		
Share capital	8,000	6,000
Share premium	2,000	1,000
Retained earnings	6,052	5,183
Total equity	16,052	12,183
Non-current liabilities		
Bank loans	0	2,280
	0	2,280
Current liabilities		
Trade payables	6,721	6,410
Tax liabilities	347	296
Bank overdraft	110	0
	7,178	6,706
Total liabilities	7,178	8,986
Total equity and liabilities	23,230	21,169

Further information:

- The total depreciation charge for the year was £1,520,000.
- Property, plant and equipment costing £450,000 with accumulated depreciation of £210,000 was sold in the year.
- All sales and purchases were on credit. Other expenses were paid for in cash.
- A dividend of £595,000 was paid during the year.

Required:

(a) Prepare a reconciliation of profit from operations to net cash from operating activities for Velani Ltd for the year ended 31 March 20X2.

(b) Prepare the statement of cash flows for Velani Ltd for the year ended 31 March 20X2.

(c) Draft the statement of changes in equity for Velani Ltd for the year ended 31 March 20X2.