Chapter 4 revision notes

Financial statements of limited companies – cash flow statement

What does the cash flow statement tell us?

Cash flow includes not only cash in hand but also deposits and overdrafts, repayable on demand with any bank or other financial institutions.

The preparation of a cash flow statement is not a legal requirement. However, FRS 1 requires all reporting entities that prepare financial statements, intended to give a true and fair view of their financial position and profit and loss, to include a cash flow statement as a primary statement within their financial statements, unless specifically exempted.

Virtually all transactions are conducted ultimately by cash or near cash (for example, bank accounts and credit cards). Sales of goods or services or, any other business assets, whether they are settled immediately or settled at some future date, are settled by cash or cash equivalents. Cash is an asset like any other asset, for example, fixed asset machinery, or current asset debtors. Cash has the same properties as other assets, but also many more:

- a unit of measurement – we evaluate transactions and report financial information in £ sterling or whatever other foreign currency denominated
- a medium of exchange – rather than using the exchange or barter of other assets, cash is used as the accepted medium, having itself a recognisable value
- a store of value – cash may be used for current requirements or held for future use

Cash, therefore, is a key asset and different from all other assets, which is why the performance of cash as a measure of business performance is so important.

The balance sheet and the profit and loss account do not show or directly deal with some of the ke changes that have taken place in the company's financial position. The cash flow statement addresses this shortfall of information by answering questions like:

- how much capital expenditure (for example, machines, and buildings) has the company made, and how did it fund the expenditure?
- what was the extent of new borrowing and how much debt was repaid?
- how much did the company need to fund new working capital requirements (for example increases in debtors and stock requirements as a result of more business activity)?
- how much of the company's funding was met by funds generated from its trading activities, and how much met by new external funding (for example, from banks and other lenders, or new shareholders)?

The cash flow statement summarises the cash inflows and outflows and calculates the net change in the cash position throughout the period. In this way it provides answers to the questions shown above by illustrating:

- changes in the level of cash between the start and end of the period
- how much cash has been generated, and from where
- for what purpose cash been used

Structure of the cash flow statement

The cash flow statement is objective and clearly avoids the problems of allocation associated with the preparation of a conventional profit and loss account and describes:

- how the company generated or lost cash
- how the company financed its growth and investments
- the extent to which the company was funded by debt and equity

The cash flow statement is covered in FRS 1, Cash Flow Statements, and its objective is to ensure that reporting entities fall within its scope:

- for companies to report their cash generation and cash absorption for a period by highlighting the significant components of cash flow in a way that facilitates comparison of the cash flow performances of different businesses
- for companies to provide information that assists in the assessment of their liquidity, solvency and financial adaptabilit

The cash flow statement lists the inflows and outflows of cash for a period classified under standard headings and follow a particular order:

- operating activities (using either the direct or indirect method)
- returns on investment and servicing of finance
- taxation
- capital expenditure and financial investment
- acquisitions and disposals
- equity dividends paid
- management of liquid resources
- financing

Direct and indirect cash flo

Net cash flow from operating activities may be derived using the direct method or the indirect method, with both methods giving the same result.

Direct method

The direct method involves individual identification of each of the cash items during the period that have been included in the profit and loss account, which are:

- cash received from customers in respect of sales
- cash paid to suppliers in respect of purchases
- cash paid to employees
- cash paid for all other expenses

Indirect method

The indirect method is by far the method most frequently adopted by UK companies. The basis of this approach is that operating revenues and costs are generally associated with cash receipts and cash payments and so profits earned from operating activities during an accounting period will approximate the net cash flows generated during the period. The actual operating cash flow may be determined from adjustment to the operating profit reported in the profit and loss account for non-cash items and changes in working capital during the period:

- stocks
- debtors
- creditors

Cash flow statement formats

There is only one standard format for the cash flow statement prescribed by FRS 1, which comprises a main statement of cash inflows and outflows, supported by schedules and notes reconciling net operating cash flow to operating profit and reconciling net cash flow to changes in net debt.

There is no statutory requirement for companies to prepare a cash flow statement. FRS 1 requires all reporting entities that prepare financial statements intended to give a true and fair view of their financial position and profit and loss, to include a cash flow statement as a primary statement within their financial statements, except for small companies which are specifically exempted.

The cash flow statement comprises a number of statements:

- reconciliation of operating profit to net operating cash flows
- cash flow statement of cash inflows and outflows
- reconciliation of net cash flow to movement in net debt
- note on gross cash flows
- note on analysis of changes in net debt

Each of these statements is important for the following reasons:

- the reconciliation of operating profit to net cash flow from operating activities shows how the net cash flow from operating activities is derived from adjusting operating profit for non-cash items and movements in working capital
- the cash flow statement reports the net cash flow for an accounting period, derived from the net cash flow from operating activities and adjusted for all non-operating categories of cash inflows and outflows
- the reconciliation of net cash flow to movement in net debt shows how the net cash flow for an accounting period is the difference between the net debt at the beginning of the period and the net debt at the end of the period
- note 1 – gross cash flows provides more detail with regard to the non-operating cash inflows and outflows used in the cash flow statement
- note 2 - analysis of changes in net debt analyses the net debt movement in greater detail to show each of the categories that comprise net debt

Undertakings preparing consolidated financial statements should prepare a consolidated cash flow statement and related notes; they are not then required to prepare an entity cash flow statement.

Cash flow links to the balance sheet and profit and loss account

The cash flow statement is directly related to both the profit and loss account and the balance sheet and the links between them may be quantified and reconciled.

The accounting standard FRS 1 (Cash Flow Statements) requires companies to provide two reconciliations included as part of the cash flow statement reporting, between:

- operating profit and the net cash flow from operating activities
  and between
- the net cash flow during the period and the movement in net debt

These reconciliations do not form part of the cash flow statement but each are provided in a supporting schedule and in a separate note. The links between cash flow and the profit and loss account may therefore be observed by way of the operating profit, adjusted for non-cash items and the changes in working capital to arrive at net cash flow from operating activities.

Opening and closing balances of cash do not appear on the face of the cash flow statement and so do not provide a direct link with the corresponding numbers reported in the balance sheet. It is for this reason that the increase or decrease in cash that appear in the cash flow statement must be reconciled with the opening and closing balance sheet numbers, the movement in net debt.

Usually this reconciliation is a simple matter of adding the increase or decrease in cash during the accounting period to the opening balance of cash and cash equivalents to agree the closing balance of cash. However, there are some situations when, in addition to the cash flows of the entity, the movement in net debt has to identify specific items, which must be reconciled to the opening and closing balance sheet amounts:

- the acquisition or disposal of subsidiaries (excluding cash balances)
- other non-cash charges
- the recognition of changes in market value and exchange rate movements

The objectivity of the cash flow statement

The preparation of the cash flow statement is a highly objective exercise, in which all the headings and amounts are cash based and therefore easily measured.

The cash flow generated during an accounting period is a matter of fact and does not rely on judgement or the use of alternative conventions or valuation methods.