Cash Flow Statements (FRS 1)

Definition

A Cash Flow Statement lists the cash flows of a business over time (usually the same period as the Profit and Loss Account).
A cash flow is any increase or decrease in cash in a business.

Purpose of Cash Flow Statements

Cash Flow Statements show information that is not available by looking at the Profit and Loss Account and Balance sheet alone. Cash Flow statements show the relationship between profitability and the ability to generate cash – in other words the "quality" of the profit earned.

Some transactions that take place in one financial year may result in further cash flows in future financial years - eg large expenditure in machinery in one year could result in good cash flows in future years.

Limited companies are required by the Company Act 1985 (and FRS 1) to produce a Cash Flow Statement together with the Profit and Loss Account and Balance Sheet.

Cash flow statements are important to shareholders because they show:

- the ability of a business to generate cash internally
- how much cash has been raised externally
- the causes of change in liquidity or cash inflows and cash outflows
- whether business can generate cash to service, finance, pay tax and maintain its fixed assets as a going concern
- stability of business reliance upon internal sources or external sources for financing
- profitability and liquidity reconciled (shareholders may confuse profitability with liquidity)
- indication of future cash flows; capital investment (expansion of activities) and its effect on future cash flows

<u>Format of the Cash Flow Statement</u>

Cash Flow Statement questions normally give <u>two years Balance</u> Sheets in order to notice any <u>changes</u> to items on which cash was spent or received.

FRS 1 requires companies to list their cash flows under the following headings:

OPERATING ACTIVITIES –
cash effects of transactions relating to normal trading activities shown in the profit and Loss account.

RETURNS ON INVESTMENTS AND SERVICING FINANCE –
interest received and paid
dividends received
dividends paid on preference shares

TAXATION -
Tax actually *paid* (NOT the tax on the Profit and Loss Account)

INVESTING ACTIVITIES –
Cash payments made to buy fixed assets
Cash received from the disposal of fixed assets

ACQUISITIONS AND DISPOSALS –
Cash from the buying or selling of other businesses

EQUITY DIVIDENDS PAID –
Cash paid for Ordinary Dividends (final dividend from last financial year and any interim dividends this year)

MANAGEMENT OF LIQUID RESOURCES –
Cash payments and withdrawals from short term deposits

FINANCING –
Cash received from the issue of shares and debentures
Cash paid when shares and debentures are redeemed

NET CASH INFLOW / OUTFLOW

The following statements must be shown under the Cash Flow Statement in order for the shareholders to be able to relate it to the Profit and Loss Account and balance Sheet:

RECONCILIATION OF OPERATING PROFIT TO NET CASH FLOW FROM OPERATING ACTIVITIES
Net profit before interest and tax *(operating profit)*
ADD Depreciation *(non-cash item)*
ADD Goodwill written off *(non-cash item)*
ADD decrease in Debtors *(sold more for cash)*
ADD decrease in Stock *(increased cash)*
ADD increase in Creditors *(increased cash if bought more on credit)*
ADD loss on disposal of fixed assets *(non –cash item)*
OR
LESS increase in Debtors
LESS increase in Stock *(used more cash on these current assets)*
LESS decrease in Creditors *(used more cash)*
LESS profit on disposal of fixed assets *(non-cash item)*

NET CASH INFLOW / OUTFLOW *(this is the figure for NET CASH FLOW FROM OPERATING ACTIVITIES on the Cash Flow Statement)*

RECONCILIATION OF NET CASH FLOW TO MOVEMENT IN NET DEBT
Net Cash Inflow (Outflow)
ADD Increase in short-term investments
LESS Increase in debentures issued
ADD Beginning Net funds (**begin** bank + cash + short term investments – debentures)

END NET FUNDS (**end** bank + cash + short term investments – debentures)

ANALYSIS OF CHANGES IN CASH AND CASH EQUIVALENTS
Balance at start of the year *(bank & cash)*
ADD Net Cash Inflow (or LESS Cash Outflow) – *from the Cash Flow Statement*
Balance at the end of the year *(same figure as bank & cash on the end Balance Sheet)*

ANALYSIS OF CHANGES IN FINANCING

	Share Capital	*Debentures*
Balance at the start of the year		
New shares / debentures issued		
Balance at the end of the year		

Steps to prepare a Cash Flow Statement

STEP 1

Prepare any workings by constructing T – accounts for items you need to calculate how much CASH was received or paid for them. This involves finding **missing figures.**

Example for Fixed Assets:

Machinery

Balance b/d	700	Disposal	105
Additions	**205**	Balance c/d	800
	905		905

Prov for depreciation on Machinery

Disposal	85	Balance b/d	300
Balance c/d	400	**P & L**	**185**
	485		485

Disposal of Machinery

Cost	105	Depreciation	85
P & L	4	**Cash**	**24**
	109		109

Example for Tax and Dividends paid:

Taxation

Cash	**84**	Balance b/d	90
Balance c/d	86	P & L	80
	170		170

Dividends

Cash	**164**	Balance b/d	116
Balance c/d	108	P & L	156
	272		272

STEP 2

Calculate the Cash Flow from Operating Activities by **preparing the Reconciliation**.

RECONCILIATION OF OPERATING PROFIT TO NET CASH FLOW FROM OPERATING ACTIVITIES

Net profit before interest and tax *(operating profit)*
ADD Depreciation *(non-cash item)*
ADD Goodwill written off *(non-cash item)*
ADD decrease in debtors and/or stock *(increased cash)*
ADD increase in creditors *(increased cash if bought more on credit)*
ADD loss on disposal of fixed assets *(non –cash item)*
OR
LESS increase in debtors and /or stock *(used more cash on these current assets)*
LESS decrease in creditors *(used more cash)*
LESS profit on disposal of fixed assets *(non-cash item)*

NET CASH INFLOW / OUTFLOW *(this is the figure for NET CASH FLOW FROM OPERATING ACTIVITIES on the Cash Flow Statement)*

IMPORTANT: Sometimes, a question may require you to calculate the Net profit before Interest and Tax (Operating Profit)

Retained profit at the end of the year
LESS Retained profit at the beginning of the year
ADD Taxation for the year
ADD proposed Dividends for the year
ADD Transfers to reserves
ADD Interest
PROFIT BEFORE INTEREST AND TAX

STEP 3

Prepare the Cash Flow Statement

STEP 4

Prepare the additional statements to the Cash Flow statement

<u>How to prepare a Balance Sheet from a Cash Flow Statement</u>

You will normally be given:

1. The previous years' Balance Sheet
2. The current years Profit and Loss Account
3. The current years' Cash Flow Statement (with Reconciliation of Operating Profit to Cash Flow from Operating Activities)

Process:

- Most amounts can be found by simply adding to (or subtracting from) the beginning balance from last years balance sheet to the amount for that item shown on the Cash Flow Statement and the Reconciliation.

- The Net Increase / Decrease in Cash should be added / subtracted to the beginning Bank balance from last years' Balance Sheet.

- The Fixed Assets ; Dividends proposed and Taxation for the year can be calculated by drawing the T-accounts for these items and finding the end Balance b/d.