

Study Notes

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Paper F1 Financial Operations

The statement of cash flows can appear to be a poor relation compared with its more established cousins, but it serves a vital purpose and, in an exam setting, is a real test of students' understanding

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The statement of cash flows is the third primary financial statement and is required by IAS7, as revised in 2008. It reports on a company's generation and use of cash, showing how the cash balance moved from its value at the start of the accounting period to its closing value, as shown on the statement of financial position. It identifies net cash flows from three broad areas of activity: operating, investing and financing.

By definition, financial statements prepared under the accruals basis take no account of actual cash flows. They focus on the economic reality of transactions, recognising income as and when it is generated and expenditure as and when it is incurred. While it may be relatively easy to secure buyers for your product or service, particularly if it's on attractive credit terms, the collection of revenue may not be as easy; it may be delayed and it may be incomplete. The generation of profit alone does not guarantee success. It's essential, therefore, that managers and investors focus not only on profit but also on cash flow. This is why the statement of cash flows is required.

The distinction between revenue and capital is a fundamental accounting concept. While the

profit for the year arising from revenue transactions is reported in the statement of comprehensive income, the statement of financial position reports, among other things, the effect of capital transactions. Both revenue and capital transactions may give rise to cash movements in or out. In effect, the statement of cash flows forms a bridge between the two statements, bringing together all transactions that have a cash implication, whether they relate to operating, investing or financing activities, and whether they are revenue or capital in nature.

Although the statements of comprehensive income and financial position – and the ratios extracted from these – are affected significantly by the choice of accounting policies, the statement of cash flows is not. It is not affected by the problems associated with the alternative approaches to profit measurement and asset valuation (covered in sections B and C of the F2 syllabus). Inter-company comparisons of statements of comprehensive income and financial position may be compromised by divergent accounting policies, but the statement of cash flows is, in essence, immune from these concerns, containing information that is consistent and neutral. A non-accountant may struggle to make sense of the statements of comprehensive income and financial position, but can usually relate to the statement of cash flows since it deals with the simple concept of cash.

In the November 2010 post-exam guide, the examiner observed that the statement of cash flows question “was either done very well or [done] very badly” and cited question-spotting as the probable main reason for this. Similarly, the September 2011 post-exam guide reported: “Candidates either knew how to do cash flows and scored fairly high marks or didn't really know what they were doing, suggesting that some had been question-spotting and had not prepared for statements of cash flow”. The statement of cash flows falls within section C of the F1 syllabus ▶

‘Someone who is not an accountant may struggle to make sense of the statements of comprehensive income and financial position, but can usually relate to the statement of cash flows’

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and is examined under learning outcome 1a. This covers the preparation of “a complete set of financial statements” and, as such, not all papers will necessarily require the preparation of a statement of cash flows. Those candidates who performed poorly could well have been gambling that the statement would not crop up in the exam, but it could simply be because they lacked a proper understanding of how the statement of cash flows interacts with the statements of financial position and comprehensive income.

As Richard Clarke wrote in his F1 article in the January/February 2011 issue (bit.ly/J4aztj): “All that a cash flow question actually asks you to do is to take the statement of comprehensive income and the statement of financial position and turn this into cash.” That is indeed the case, but in doing so you are showing how well you understand the whole financial accounting package. Preparing a statement of cash flows requires the unravelling of the effect of several transactions that have occurred over the year. The examiner wants to know whether you understand how the elements on the statement of financial position have gone from their opening positions to their closing positions, and the extent to which cash movement has been involved.

Let’s work through the following illustrative question, which requires us to complete a company’s statement of cash flows for the year ended 31 December 2011, in accordance with IAS7. The abridged reports relate to Earl, a retail business in the outdoor pursuits sector. All figures quoted are in thousands of dollars.

EARL’S INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2011

Operating profit	2,976
Net finance cost (see note 1)	(48)
Loss on disposal of plant	(96)
Profit before taxation	2,832
Taxation	(672)
Profit attributable to ordinary shareholders	2,160

Note 1. The net finance cost consists of interest payable of 240 and interest receivable of 192. No sums were accrued at either the beginning or the end of the year.

EARL’S STATEMENT OF FINANCIAL POSITION

	31 December 2011	31 December 2010
ASSETS		
Non-current assets (see note 2)	7,920	7,152
Inventory and receivables	8,064	6,576
Cash	2,928	288
Total assets	18,912	14,016
EQUITY AND LIABILITIES		
Capital and reserves		
Share capital (ordinary shares of \$1 each)	3,456	3,120
Share premium account	1,008	960
Retained earnings	4,512	2,688
Total equity	8,976	6,768
Non-current liabilities	2,592	2,304
Current liabilities (see note 3)	7,344	4,944
Total liabilities	9,936	7,248
Total equity and liabilities	18,912	14,016

Note 2. Analysis relating to non-current assets is as follows:


Cost as at 1 Jan 2011	8,784
Cost as at 31 Dec 2011	10,224
Accumulated depreciation as at 1 Jan 2011	1,632
Accumulated depreciation as at 31 Dec 2011	2,304

The year saw both an investment in new plant and the sale of some assets, which had been held for two years. These assets had been purchased for 480 and were subject to depreciation on a straight-line basis at a rate of 15 per cent.

Note 3. Current liabilities:

	2011	2010
Bank overdraft	240	576
Trade payables	6,480	3,840
Final dividends	144	240
Taxation	480	288
	7,344	4,944

The cash generated from operations and from financing activities have already been derived. These figures are 4,944 and 240 respectively.

You are required to complete the identification of the net cash from operating activities and to compute the cash flows resulting from investing activities. These are to be shown in an abbreviated 

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statement containing the net cash flows from each of the three activities; the net flow of cash during the year; the cash balance at 1 January 2011; and the cash balance at 31 December 2011.

The first step in answering the question is to deduct any interest and tax paid from the cash generated from operations. The deductions must represent the sums physically paid in the year. So, for taxes, combine the provision brought forward with the new charge arising in the year and deduct the amount outstanding at the year end. The net cash from operating activities is therefore as follows:

Cash generated from operations	4,944
Interest paid	(240)
Tax paid: 288 + 672 – 480	(480)
Net cash inflow from operating activities	4,224

The second step is to identify cash flows from investing activities. This requires close scrutiny of the movements in non-current assets. The question does not provide a schedule of those movements, so some detective work is required to establish the sums invested in new assets and the effect of asset disposals. Additions may be derived as follows:

Working A: value of additions	
Opening cost	8,784
Cost of assets sold	(480)
	8,304

This figure can then be subtracted from the closing cost to arrive at the cost of additions: 10,224 – 8304 = 1,920.

The consideration received on asset disposals will be known by the company accountant, but in this question you need to derive the figure by comparing the net book value of the assets sold (which we need to calculate) with the loss on their disposal reported in the income statement. This is done as follows:

Working B: asset disposal	
Net book value: 480 – [480 x 15% x 2 years]	336
Loss on disposal, as per income statement	(96)
Proceeds on disposal	240

Once the depreciation charged on the assets sold has been calculated, we can identify the depreciation charged for the year in the income statement. This is the figure to be adjusted out

to arrive at operating profit before the working capital changes. In this case the adjustment required has already been reflected in the cash generated from operations of 4,944.

Working C: depreciation charge for the year

Opening provision	1,632
Depreciation on asset sold: 480 x 15% x 2 years	(144)
	1,488

This figure can then be subtracted from the closing provision to arrive at the charge for the year: 2,304 – 1,488 = 816.

These workings test your understanding of accounting for non-current assets. To complete the section relating to cash flows from investing activities, we recognise any investment income received as follows (note that IAS7 also permits the recognition of interest receivable as an operating cash flow):

Cash flows from investing activities

Purchase of plant [working A]	(1,920)
Proceeds from disposal of plant [working B]	240
Interest received [note 1]	192
Net cash used in investing activities	(1,488)

The final step is to combine cash flows from all three areas of activity and then merge the total movement with the opening net cash balance to arrive at the net cash balance at the end of the period as follows (in this case the net cash balances are obtained from netting the overdraft off against the cash asset):

EARL'S ABBREVIATED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2011

Net cash from operating activities	4,224
Net cash used in investing activities	(1,488)
Net cash from financing activities	240
Net inflow of cash and cash equivalents	2,976
Cash and cash equivalents at 1 Jan 2011: 288 – 576	(288)
Cash and cash equivalents at 31 Dec 2011: 2,928 – 240	2,688

'Preparing a statement of cash flows requires the unravelling of the effect of several transactions that have occurred over the year'

Perhaps the key to success in approaching the statement of cash flows is to treat it not as a separate topic, but as the completion of the financial reporting triangle, whether that's in the context of a single company or a group.