FINANCIAL ANALYSIS

Francis Braganza explains how to prepare a cash flow statement, using November 2005's question as an example, with dates advanced two years.

It is said that the aim of cash flow reporting is to explore ways in which the underlying liquidity of a reporting entity can be revealed in accounting terms. Profit is regarded as an indicator of financial success, but, as anyone running a business will tell you, cash is king. The measurement of profit is usually based on a mixture of factual transactions and unavoidable subjective accounting judgments.

"The stock market prefers the fantasy of smooth growth to the reality of fluctuating operational performance. It falls to the creative accountant to ensure that those fluctuations are removed by hoarding profits in years of plenty for release in years of famine… Just like sin, cash flow will eventually find a company out." So wrote Ian Griffiths in his bestseller *Creative Accounting*.

The Financial Analysis paper comes as a bit of a shock to some candidates, especially the area of consolidations. From time to time there is no balance sheet or income statement to prepare, but a group cash flow statement may be required. Sometimes cash flows are examined in the objective testing part of the paper (section A) and sometimes they are included as part of analysis and interpretation, as in May 2007's 25-marker in section C. But any syllabus topic can be examined in any section of the paper, so it's not out of the question that cash flow could be examined in section B.

I firmly believe that, if you know the three-category format prescribed by IAS7 and – crucially – you follow the *non*-T accounts approach, you will be pleased to see this topic on your question paper.

Consolidation – ie, presenting the financial information of the group as if it were a single economic entity – is based on the key principle that "no man can make a profit by trading with himself". Accordingly, internal cash flows should be eliminated in preparing a consolidated cash flow statement. A dividend paid to a minority interest crosses the boundary of the group and should be shown under category three, as in the list in the panel on the left.

I understand that no particular form of consolidation working schedule will be required, since the examiner recognises that a variety of good practices exists in this area. But I feel that, while they aid people's understanding of financial accounting, using T-accounts as workings for a cash flow statement may be a waste of precious time, so it's probably helpful to get accustomed to making a columnar presentation of workings in all contexts.

Let's consider the exam question from the November 2005 paper: extracts from the consolidated financial statements of the AH Group for the year ended June 20, 2007 are given in tables 1 to 3.

We are also given the following notes:

1 Several years ago, AH acquired 80 per cent of the issued ordinary shares of its subsidiary, BI. On January 1, 2007, AH acquired 75 per cent of the issued ordinary shares of CJ in exchange for a fresh issue of two million of its own $1 ordinary shares (issued at a premium of $1 each) and $2m in cash. CJ's net assets at the date of acquisition were assessed as having the following fair values:

Group adjustments

1. A dividend received from an associate by a parent is an inflow (investing activities: second category).
2. A dividend paid to a minority interest by a subsidiary is an outflow (financing activities: third category).
3. Net cash paid out to acquire a subsidiary during the year is an outflow (investing activities: second category). Exam danger point: deduct incoming cash, add any overdraft and ignore shares issued.
4. Reverse the above for the disposal of subsidiary – ie, treat it as an inflow.
5. When doing working capital changes, allow for incoming subsidiaries' figures. Also do so for non-current asset purchases, minority interests, tax etc.

1 AH Group: consolidated income statement for the year to June 20, 2007

	$000
Revenue	85,000
Cost of sales	59,750
Gross profit	25,250
Operating expenses	5,650
Profit from operations	19,600
Finance cost	1,400
Profit before disposal of property	18,200
Disposal of property (note 2)	1,250
Profit before tax	19,450
Income tax	6,250
Profit for the period	13,200
Attributable to:	
Minority interest	655
Group profit for the year	12,545
	13,200

2 AH Group: extracts from statement of changes in equity for the year to June 20, 2007

	Share capital $000	Share premium $000	Consolidated revenue reserves $000
Opening balance	18,000	10,000	18,340
Issue of share capital	2,000	2,000	
Profit for period			12,545
Dividends			(6,000)
Closing balance	20,000	12,000	24,885

3 AH Group: balance sheet, with comparatives, at June 20, 2007

	2007		2006	
	$000	$000	$000	$000
ASSETS				
Non-current assets				
Property, plant and equipment	50,600		44,050	
Intangible assets (note 3)	6,410		4,160	
		57,010		48,210
Current assets				
Inventories	33,500		28,750	
Trade receivables	27,130		26,300	
Cash	1,870		3,900	
		62,500		58,950
		119,510		107,160
EQUITY AND LIABILITIES				
Equity				
Share capital	20,000		18,000	
Share premium	12,000		10,000	
Consolidated revenue reserves	24,885		18,340	
		56,885		46,340
Minority interest		3,625		1,920
Non-current liabilities				
Interest-bearing borrowings		18,200		19,200
Current liabilities				
Trade payables	33,340		32,810	
Interest payable	1,360		1,440	
Tax	6,100		5,450	
		40,800		39,700
		119,510		107,160

Property, plant and equipment	$4,200,000
Inventories	$1,650,000
Receivables	$1,300,000
Cash	$50,000
Trade payables	($1,950,000)
Tax	($250,000)
	$5,000,000

2 During the year, AH disposed of a non-current asset of property for $2,250,000. The carrying value of the asset at the date of disposal was $1m. There were no other disposals of non-current assets. Depreciation of $7,950,000 was charged against consolidated profits for the year.

3 Intangible assets comprise goodwill on the acquisitions of BI and CJ (only BI in 2006). Goodwill has remained unimpaired since acquisition.

The question requires you to prepare the consolidated cash flow statement of the AH Group for the financial year ended June 30, 2007 in the form required by IAS7, "Cash flow statements", using the indirect method. Notes to the cash flow statement are not required, but full workings should be shown. There are 25 marks available.

Always remember that the total of the cash flow statement is available from the question, which can usually be found within the first few seconds of reading – there aren't many topics in this vast syllabus that I can say that about.

First, open up a new page with the heading "AH Group: consolidated cash flow statement for the year to June 30, 2007". Keep two pages aside for this document. Then move directly to the next page to set up your first working (*see panel, above*). I would recommend immediately moving back to the last line of your cash flow statement and slotting in this $2,030,000 figure. You now have something to aim at.

At the same time, put in cash at start of year of $3,900,000 and cash at end of year of $1,870,000. As many as two marks are available for these three lines – almost ten per cent of what's on offer.

I wouldn't draft an "empty" pro-forma answer (an outline cash flow statement) with no figures entered. That would score one mark at the most. If you are running out of time, you would be better off completing the calculations for part of a question than to give a "blank" response to all of it.

Next, head up the first category "Cash flows from operating activities". Start with the profit before tax of $19,450,000, add back the depreciation for the year of $7,950,000, deduct the profit on disposal of property of $1,250,000 and add back the finance cost of

Working one: overall change in cash and cash equivalents

	Closing	Opening
Cash	$1,870,000	$3,900,000

= a decrease of $2,030,000, which is the cash flow statement total

Working two: inventories, receivables and payables

	Inventories $000	Receivables $000	Payables $000
Opening	28,750	26,300	32,810
Add: acquired with CJ	1,650	1,300	1,950
Opening has become	30,400	27,600	34,760
But closing is	33,500	27,130	33,340
Cash flow is therefore	3,100	470	1,420
	Outflow	Inflow	Outflow
	(since more bought off)	(AH collected some)	(paid some off)

Working three: interest and tax	Interest $000	Tax $000
Opening	1,440	5,450
Liability acquired with CJ	–	250
Income statement charge	1,400	6,250
Opening has become	2,840	11,950
But closing is	1,360	6,100
Cash outflow is therefore	1,480	5,850

Working five: minority interest	$000
Opening	1,920
Acquired with CJ (25% of net assets)	1,250
Consolidated income statement	655
Opening has become	3,825
But closing is	3,625
Paid out as a minority dividend	200

Working four: property, plant and equipment	$000
Opening	44,050
Acquired with CJ	4,200
Less disposal (note 2)	(1,000)
Less depreciation for year	(7,950)
Opening has become	39,300
But closing is	50,600
Therefore purchased outflow is	11,300

$1,400,000. The key concept here is to do the opposite of what was done in the income statement, negating the earlier treatment so as to write on a clean slate what is purely cash.

It is important that the direction of the figures must be right. For example, adding $1,250,000 rather than deducting it shows a serious lack of understanding, which will be penalised by the exam markers.

Now go back to your workings page for the working capital changes. Head up three columns "Inventories", "Receivables" and "Payables". Start by putting in the opening balances. Then add the items acquired with subsidiary CJ, as in working two at the bottom of page 54.

Try not to use T-accounts for this, because it would be slower and more prone to error. I do not use brackets either, as this can be easily handled in the cash flow statement as unbracketed inflows or bracketed outflows. Also, too many brackets in workings tend to drag down the technique into the T-accounts realm – ie, showing too many movements – and could cause error. Having moved away from T-accounts for consolidations, I find it easier to do no T-accounts at all in the paper. Do take time to consider this approach carefully: when the orthodox is being challenged, nothing can be regarded as simple. But, in time, you will see the benefits.

AH Group: consolidated cash flow statement for the year to June 30, 2007	$000	$000
CASH FLOWS FROM OPERATING ACTIVITIES		
Profit before tax	19,450	
Adjustments: add depreciation for year	7,950	
less profit on disposal of property (2,250 – 1,000)	(1,250)	
add finance cost	1,400	
Increase in inventories (working two)	(3,100)	
Decrease in receivables (working two)	470	
Decrease in payables (working two)	(1,420)	
Cash generated from operations	23,500	
Interest paid (working three)	(1,480)	
Tax paid (working three)	(5,850)	
Net cash from operating activities		**16,170**
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition of CJ (2,000 – 50 incoming cash)	(1,950)	
Purchase of property, plant and equipment (working four)	(11,300)	
Sale proceeds of property, plant and equipment (given)	2,250	
Net cash used in investing activities		**(11,000)**
CASH FLOWS FROM FINANCING ACTIVITIES		
Repayment of interest-bearing borrowings (19,200 – 18,200)	(1,000)	
Dividend paid (from statement of changes in equity)	(6,000)	
Dividend paid to MI (working five)	(200)	
Net cash used in financing activities		**(7,200)**
Net decrease in cash		**(2,030)**
Cash at start of year		**3,900**
Cash at end of year		**1,870**

The figure for cash generated from operations is $23,500,000 (*see the final consolidated cash flow statement, above*). From this we must deduct interest or finance cost paid and tax paid. These too can be done in columnar, non-T-accounts style, using the more – dare I say it – modern approach, as in working three at the top of this page. I understand that there are separate marks for calculation as well as for direction when presenting these in the main cash flow statement, so do be careful.

This should give a total of $16,170,000 for the first category, "Net cash from operating activities". So far we'll have scored 17 marks – a comfortable pass – but we can also do workings four and five. The actual cash flow statement now becomes simple (*see above*).

Practise as many questions as possible. Remember that wise piece of advice: I hear, I forget; I see, I remember; I do, I understand.

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