BASIC TRAINING PROGRAM FOR COMMERCIAL DIVISION JUDGES

Cash Flow Statement

(Introduction to Finance and Accounting - Part Two)

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Teslić

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T A B L E O F C O N T E N T

INTRODUCTION

In the first part of the manual "Introduction to Finance and Accounting", intended exclusively for judges of the newly formed commercial divisions, within the basic training program, we spoke about the importance of communication through financial reports. Namely, financial reports are basic means for communicating important accounting data to their users. Just like all other models, financial reports do not give the perfect picture of the actual situation, but we would say that they are accountant's best attempt to present the actual situation.

There are three main financial reports for communicating accounting information about a business, and they are as follows:

- *Income Statement;*
- *Balance Sheet; and*
- *Cash Flow Statement.*

Let us remind ourselves that the income statement shows the sum depiction of earnings and expenses in the course of regular business during a certain time period. Many regard it as the most important financial statement for it shows whether a business has been profitable, i.e. whether it generated acceptable net profit.

When we talked about the balance sheet, we said that the purpose of that statement was to show financial situation of a financial entity on a certain date, usually at the end of a month or a year. Balance sheet is often referred to as the statement on financial situation, and gives the overview of business activities in terms of resources and funding sources. Those sources are comprised of company's liabilities and company's own equity.

In this part of the manual we shall talk about the cash flow statement. While the primary purpose of the income statement is to show profitability, the cash flow primarily aims to depict liquidity of a company. From the following pages you will learn what the goals are in composing the cash flow statement, what the methods used are, and how data, obtained by implementation of those methods, is interpreted.

«The goal of financial reports is provide information about a business, which is significant in business decision making for majority of users.»

(Committee for International Accounting Standards)

1. CASH FLOW STATEMENT

GOALS OF THE TRAINING:

- Identify questions that the cash flow statement answers
- Explain operative, investment, and financial activities
- Utilize cash flow statements in analysis of a financial statement
- Build skills through practical examples

Besides the Balance Sheet and Income Statement, the third financial statement to be analyzed is the Cash Flow Statement. As indicated by its title, this statement on company's business shows how the company acquires and utilizes cash sources. Data that makes the cash flow statement is obtained from the income statement and the balance sheet.

Since debts are repaid with cash, the cash flow statement helps an analyst determine financial needs of a company and repayment sources.

Cash flow statement shows INFLOW and OUTFLOW of cash according to following categories:

- Flow of working capital
- Investments
- Investment financing.

1.1. <u>CONCEPT OF CASH AND CASH EQUIVALENTS</u>

The following is considered cash:

- local and foreign currency money in a cash box;
- local and foreign currency money in deposit bank accounts, and
- opened letters of credit in the country and abroad.

Cash equivalents are securities that can be directly converted to cash with trivial risk (received checks, for example).

In composing cash flow statements, cash and cash equivalents are uniformly treated under the single item. Cash flow statement results in the status of cash and cash equivalents on the date of the statement.

1.2. SEGMENTS OF THE CASH FLOW STATEMENT

Cash flow statement has three segments (parts):

a) cash flow in operating activities;
b) cash flow in investment activities; and
c) cash flow in financing activities.

a) Cash Flow in Operating Activities

(«business/operative activities» are the main activities that generate company's income and other activities, besides investment and financing activities)

The amount of cash flows resulting from operative activities is the key indicator of the extent to which the company's activities generated sufficient cash flows to repay loans, maintain operative capacity of the company, distribute dividends, and make new investments, without reaching out to external sources of financing.
Information on specific components of past cash flows is useful in synthesis with other information when forecasting future operative flows.

Cash flows from operative activities result from main activities of a company that generate income. Therefore, they are the outcome of transactions and other events that determine net profit or loss.

The examples of cash flows from operative activity are as follows:

a) cash received from sale of goods or services;
b) cash revenues from intellectual and other proprietary rights, fees, commissions, and other proceeds (premiums, refunds...);
c) cash payments to suppliers of goods and services;
d) cash payments to employees and for their accounts (payment of taxes and contributions on earnings);
e) cash revenues and expenses of insurance company for premiums and damage compensations, leases, and other proceeds on the policy;
f) cash payments and income tax refunds, unless they can be individually associated with investment and financing activities; and
g) cash revenues and payments from contracts, maintained for purpose of business and trade.

Some transactions, such as sale of facility elements, can increase profit or loss. However, cash flows related to such transactions are cash flows from investment activities.

A company can hold securities for purpose of doing business or trading, in which case they are similar to inventory acquired specifically for sale. Therefore, cash flows resulting from purchase and sale of securities in doing business or trading are classified as operative activities.

b) *Cash Flow in Investment Activity*

(«investment activities» are long-term acquisition and disposition of assets and other investments not involving cash equivalents)

Separate depiction of cash flows resulting from investment activities is significant because cash flows represent the extent to which expenses have been incurred for resources intended to generate future income and cash flows.

The examples of cash flows resulting from investment activities are as follows:

a) cash payments for purchase of land and buildings, facilities and equipment, intangible fixed assets, and other fixed assets;
b) cash revenues from the sale of land and buildings, facilities and equipment, intangible fixed assets, and other fixed assets;
c) cash payments for purchase of stock capital or indebtedness instruments of other companies, and interest in joint ventures (except payments for those instruments considered cash equivalents, or those maintained for purpose of doing business and trading);
d) cash revenues from the sale of stock capital or indebtedness instruments of other companies, and interest in joint ventures (except revenues for those instruments considered cash equivalents, or those maintained for purpose of doing business and trading);
e) cash advances and loans provided for other parties;
f) cash revenues from repayment of advances and loans provided for other parties;
g) cash payments for term contracts, contracts on advance purchases, contracts with the right of purchase and sale, and contracts on trade, except when they maintained for the purpose of doing business or trading, or the payments are classified as financing activities;
h) cash revenues for term contracts, contracts on advance purchases, contracts with the right of purchase and sale, and contracts on trade, except when they maintained for the purpose of doing business or trading, or the revenues are classified as financing activities.

When a contract is considered as coverage for craft operation of recognizable position, cash flows of such contract are classified in the same way as cash flows of the position that is covered by craft operation.

c) *Cash flow in Financing*

(«financing activities» are activities that result in changes of size and composition of own equity and liabilities on obtained loans)

Separate depiction of cash flows that result from financing activities is significant because it is useful in forecasting of claiming rights to future cash flows by suppliers of the company's capital.
The examples of cash flows resulting from financing activities are as follows:

a) total amount of cash from emission of shares or other instruments of stock capital;
b) cash payments to owners in order to obtain stocks of a company;
c) total amounts of cash from emission of bonds, loans, bills of exchange, coupons, mortgages, and other short-term or long-term credits;
d) cash payments of borrowed amounts;
e) and cash payments by lease holder to reduce outstanding debt related to financial loan.

2. COMPOSING THE CASH FLOW STATEMENT

Cash flow statement can be composed using *direct* and *indirect* method.

1. Direct method of cash flow statement shows main types of cash revenues and cash payments, of course segmented to: cash flow in operating activity, cash flow in investment activity, and cash flow in financing.

Sales -net	
(Increase) decrease in receivables	
Cash from sales	
(Cost of goods sold)[1]	
(Increase) decrease in inventories	
Increase (decrease) in payables	
Cash production costs	
Gross cash profit	
(Selling, general and administrative expense)[1]	
(Increase) decrease in prepaids	
Increase (decrease) in accruals	
Cash operating expense	
Cash after operations	
Miscellaneous cash income[2]	
Income taxes paid[3]	
Net cash after operations	
Interest expense	
Dividends paid/ owner withdrawals	
Financing costs	
Net cash income	
Current portion long-term debt[4]	
Cash after debt amortization	
Capital expenditures[5]	
Long-term investments/ intangibles	
Financial surplus (requirements)	
Increase (decrease) short-term debt	
Increase (decrease) long-term debt[6]	
Increase (decrease) equity[7]	
Total external financing	
Cash after financing	
Actual change in cash	

2. *Indirect method* of cash flow statement in cash flow from operating activity starts with net profit (or loss), and then follows the correction to higher and lower in order to reach the cash balance on the date of the statement (resulting from operative activity).

1	Net income after tax
2	Depreciation
3	+/- changes on Accounts Receivable
4	+/- changes in Inventory
5	+/- changes on other Current Assets Account
6	+/- changes on Accounts Payable
7	+/- changes on Accrued Expenses
8	+/- changes on Accrued and delayed taxes on income
9	+/- changes on other Current Liabilities Accounts
10	+/- changes on other Noncurrent Liabilities
11	**Operating funds flows (Operating Cash Flow)**
12	+/- changes on Securities Account
13	+/- changes in Long Term Investment
14	+/- changes in Gross Fixed Assets
15	Non expected profit (loss)
16	Intangible and Other Assets
17	**Investing funds flows**
18	***Cash flow before Financing Activities (row 11 + row 17)***
19	+/- changes in Short Term Loan
20	+/- changes in Long Term Loan
21	+/- changes in Subordinated Loan
22	+/- changes in Capital
23	Dividends paid
24	Adjustments on Retained Earning Account
25	Other Interest
26	**Financing funds flows**
27	**TOTAL CASH FLOW (row 11+ row 17 + row 26)**
28	Beginning Cash
29	Plus Operating cash flow (row 11)
30	Investing cash flow (row 17)
31	Financing cash flow (row 26)
32	Ending Cash

Gross profit increases (and loss decreases) on the basis of:

- depreciation and expenses of long-term contingencies – because neither is directly related to cash expenses;
- expenses of financing with cash expenses related to investment in fixed assets – because cash expenses on that basis are assessed within the investment activity.

Negative exchange rates on the basis of investment activity (loans extended in foreign currency) increase gross profit because they are included in the cash flow from investment activity.
Also, negative exchange rate differences based on foreign currency in cash, or in the foreign currency deposit account depicted in the opening balance, increase gross profit because they reduce the cash transferred from the previous year;

- reduced receivables from operations in closing balance compared to receivables in the opening balance – for this also represents source of cash;
- increased liabilities from operations in closing balance compared to liabilities from operations in opening balance – for this represents decreased outflow of cash;
- capital losses on the basis of the sale of fixed assets – for this is the integral part of cash flow from investment activity;
- tax refund on result – for this represents inflow of cash.

Gross profit decreases (and loss increases) on the basis of:

- revenue from financing resulting from investment activity, also including positive exchange rate differences made on that basis – for it is included in the cash flow from investment activity.
  In the same manner, positive exchange rate differences are excluded on the basis of foreign currency found in the cash box or foreign currency deposit account in the opening balance, because they perform correction of cash shown in the opening balance;
- increase of inventory in the closing balance compared to inventory in the opening balance – for this represents investment of cash;
- increase of receivables from operations in the closing balance compared to receivables in the opening balance – for this also represents investment of cash;
- decrease of liabilities from operations in the closing balance compared to liabilities from operations in the opening balance – for this also represents outflow of cash;
- income from activating effects for fixed assets, or building and reconstructing fixed asset at own expense – for this represents investment of cash;
- capital income from the sale of fixed assets – for this is integral part of the cash flow from investment activity;
- paid taxes on result – for this represents outflow of cash.

It is crucial for a company to have positive net cash flow from operating activity, because investment and financing depend on it.
When reporting on net cash flow it is obligatory to present both the net cash flow for the current year and for the previous year, aiming to show changes and tendencies of the net cash flow. In interpreting those changes and tendencies, an analyst associates them with results of financial result analysis, property situation, and financial situation.