# ACCOUNTING AND FINANCE

## FOR NON-SPECIALISTS

Twelfth Edition

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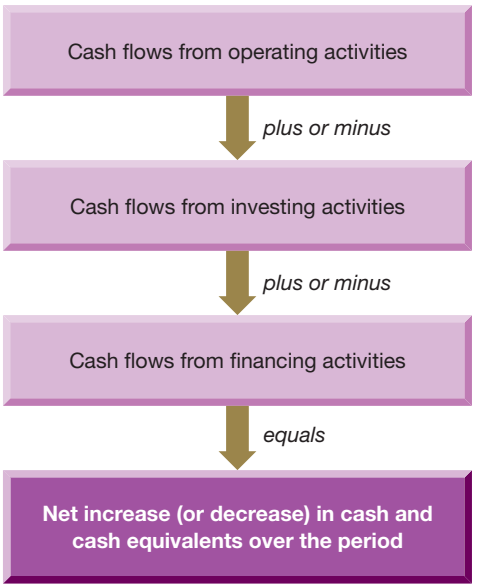
## FOR NON-SPECIALISTS

## THE LAYOUT OF THE STATEMENT OF CASH FLOWS

As mentioned earlier, the cash flows of a business are divided into categories. The various categories and the way in which they are presented in the statement of cash flows are shown in Figure 5.3.




This presentation for the statement of cash flows is in accordance with IAS 7 *Statement of Cash Flows.*

**Figure 5.3** Standard presentation for the statement of cash flows

Let us now consider each of the categories that have been identified.

### Cash flows from operating activities

These represent the cash inflows and outflows arising from normal day-to-day trading activities, after taking account of the tax paid and payments relating to financing costs (for equity and borrowings) linked to these activities. The cash inflows for the period are the amounts received from trade receivables (credit customers settling their accounts) and from cash sales for the period. The cash outflows for the period are the amounts paid for inventories, operating expenses (such as rent and wages) corporation tax, interest and dividends.

Note that it is the cash inflows and outflows (that is, actual cash receipts and payments) during a period that appear in the statement of cash flows, not revenue and expenses for that period. Similarly, tax and dividends that appear in the statement of cash flows are those actually paid during the period. We saw in Chapter 4 that larger companies pay tax on their annual profits in four equal instalments. Two of these are paid during the year to which they relate and the other two are paid after the end of that year. Thus, by the end of each year, half of the tax will have been paid and the remaining half will still be outstanding. This outstanding amount will be paid during the following year. The tax payment during a year is, therefore, equal to half of the previous year's tax charge and half of that of the current year. It is this total that should appear in the current year's statement of cash flows.

## Cash flows from investing activities

These include cash outflows to acquire non-current assets and cash inflows from their disposal. In addition to items, such as property, plant and equipment, non-current assets might include financial investments made in loans or shares in another business.

This section of the statement of cash flows also includes cash inflows *arising from* financial investments (loans and shares).

### Activity 5.3

**What might be included as cash inflows from financial investments? Try to think of at least one example.**

This can include proceeds from the repayment of a loan made by the business and proceeds from the disposal of shares in other companies.

Under IAS 7, interest received and dividends received could, if the directors chose, be classified under *Cash flows from operating activities.* This alternative treatment is available as these items appear in the calculation of profit. For the purpose of this chapter, however, we shall include them in *Cash flows from investing activities.*

## Cash flows from financing activities

These represent cash inflows and outflows relating to the long-term financing of the business.

### Activity 5.4

**What might be included as cash inflows from financing activities? Try to think of at least one example.**

This would include cash movements relating to the raising of both long-term borrowings and shares.

Under IAS 7, interest and dividend paid by the business could, if the directors chose, appear under this heading as outflows. This alternative to including them in *Cash flows from operating activities* is acceptable as they represent a cost of raising finance. For the purpose of this chapter, however, we shall not use this alternative treatment.

Whichever treatment for interest and dividends (both paid and received) is chosen, it should be applied consistently.

## Net increase or decrease in cash and cash equivalents

The final total shown on the statement will be the net increase or decrease in cash and cash equivalents over the period. It will be deduced from the totals from each of the three categories mentioned above.

**Real World 5.3** shows the summarised statement of cash flows of Tesco plc, the UK-based supermarket company.

## REAL WORLD 5.3

### Cashing in

A summary of the statement of cash flows for Tesco plc for the 52 weeks ended 29 February 2020 shows the cash flows of the business under each of the headings described above.

**Summary group statement of cash flows for the 52 weeks ended 29 February 2020**

| | £m |
|---|---|
| Cash generated from operations | 1,181 |
| Interest paid | (803) |
| Corporation tax paid | (340) |
| **Net cash generated from operating activities** | 38 |
| **Net cash generated from investing activities** | 2,408 |
| **Net cash used in financing activities** | (1,912) |
| **Net increase in cash and cash equivalents** | 534 |

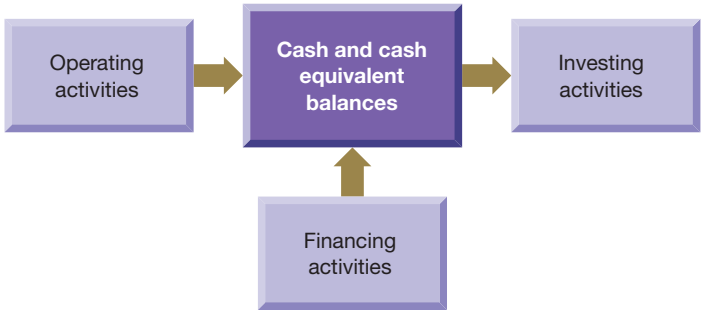
*Source*: Adapted from Tesco plc, Annual Report and Financial Statements 2020, p. 83, www.tescoplc.com.

As we shall see shortly, more detailed information under each of the main headings is provided in the statement of cash flows presented to shareholders and other users.

## THE NORMAL DIRECTION OF CASH FLOWS

The effect on a business's cash and cash equivalents of activities relating to each category is shown in Figure 5.4. The arrows show the *normal* direction of cash flow for the typical, profitable, business in a typical reporting period.

Normally, *operating activities* provide positive cash flows and, therefore, increase the business's cash resources. For most UK businesses, cash generated from day-to-day trading, even after deducting tax, interest and dividends, is by far the most important source of new finance.




Various activities of the business each have their own effect on the total of the cash and cash equivalents, either positive (increasing the total) or negative (reducing it). The net increase or decrease in the cash and cash equivalents over a period will be the sum of these individual effects, taking account of the direction (cash in or cash out) of each activity.

Note that the direction of the arrow shows the *normal* direction of the cash flow in respect of each activity. In certain circumstances, each of these arrows could be reversed in direction.

**Figure 5.4** Diagrammatical representation of the statement of cash flows

## Activity 5.5

**Last year's statement of cash flows for Angus plc showed a negative cash flow from operating activities. What could be the reason for this and should the business's management be alarmed by it? (*Hint*: We think that there are two broad possible reasons for a negative cash flow.)**

The two reasons are:

1. The business is unprofitable. This leads to more cash being paid out to employees, to suppliers of goods and services, for interest and so on than is received from trade receivables. This should be of concern as a major expense for most businesses is depreciation. Since depreciation does not lead to a cash flow, it is not considered in *net cash flows from operating activities.* A negative operating cash flow might well indicate, therefore, a much larger trading loss – in other words, a significant loss of the business's wealth. This is likely to be a source of concern for management.
2. The business is expanding its activities (level of sales revenue). Although the business may be profitable, it may be spending more cash than is being generated from sales. Cash will be spent on acquiring more assets, non-current and current, to accommodate increased demand. For example, a business may need to have inventories in place before additional sales can be made. Similarly, staff will have to be employed and paid. Even when additional sales are made, they would normally be made on credit, with the cash inflow lagging behind the sales. This means that there would be no immediate cash benefit.

Expansion often causes cash flow strains for new businesses, which will be expanding inventories and other assets from zero. They would also need to employ and pay staff. To add to this problem, increased profitability may encourage a feeling of optimism, leading to a lack of attention being paid to the cash flows. Although the cause of the cash flow problem is less disturbing than a lack of profitability, the effect could be a severe strain on cash resources and the consequent dangers of this.

Investing activities typically cause net negative cash flows. This is because many non-current assets either wear out or become obsolete and need to be replaced. Businesses may also expand their asset base. Non-current assets may, of course, be sold, which would give rise to positive cash flows. In net terms, however, the cash flows are normally negative, with cash spent on new assets far outweighing that received from the sale of old ones.

Financing activities can go in either direction, depending on the financing strategy at the time. Since businesses seek to expand, however, there is a tendency for these activities to result in cash inflows rather than cash outflows.

Before leaving this section let us consider **Real World 5.4.** It illustrates how the Covid-19 pandemic has put a huge strain on the cash flows of a well-known aerospace manufacturer.

## REAL WORLD 5.4

# Bleeding to death?

Chief executive Guillaume Faury told Airbus employees in a letter that the company is rapidly "bleeding cash", which threatens the manufacturer's existence. The plane maker said on April 8 that it will slash production by a third, but Mr Faury told the workforce of 133,000 on Friday that the production cuts were not the worst-case scenario. Airbus has lost a third of its business in a matter of weeks, as the pandemic has hammered airlines' revenue and made them reluctant to accept new jets. "We're bleeding cash at an unprecedented speed, which may threaten the very existence of our company," Mr Faury wrote. "We must now act urgently to reduce our cash-out, restore our financial balance and, ultimately, to regain control of our destiny."

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Mr Faury wrote that the company has moved quickly to secure credit lines to adapt and resize the business. Airbus declined to comment on the internal communication. The aviation market is expected to shrink substantially following the Covid-19 crisis, an abrupt reversal from the future that forecasters at Airbus and rival Boeing envisioned just a few months ago. With airlines such as Virgin Australia in administration, and passenger demand not expected to recover to 2019 level for years, many airlines are waiting to see what capacity they will need in 2021.

Carter Copeland, a Melius Research analyst, wrote in a note that production rates at both aerospace manufacturers will fall 40 per cent in 2020 and 2021 compared to levels two years ago. "For our adjusted 2020 production rates, we think aircraft construction already under way with (in many cases) pre-existing financing and sizeable advances can help support these delivery rates," he said. "However, the longer that massive capacity reductions persist, the more we worry about the ability/desire of airlines to take aircraft deliveries in 2021." First-quarter cash flows at Airbus and Boeing are expected to break records. Mr Copeland is forecasting a €6.5bn outflow at Airbus, which includes a €3.6 billion compliance fine, and $8 billion at Boeing.

FT *Source*: Bushey, C. (2020) 'Airbus is "bleeding cash", says chief executive', *Financial Times,* ft.com, 27 April.


# PREPARING THE STATEMENT OF CASH FLOWS

## Deducing net cash flows from operating activities

As we have seen, the first category within the statement of cash flows is the *Cash flows from operating activities.* There are two approaches that can be taken to deriving this figure: the **direct method** and the **indirect method**.

### *The direct method*

The direct method involves an analysis of the cash records of the business for the period, identifying all payments and receipts relating to operating activities. These receipts and payments are then summarised to provide the total figures for inclusion in the statement of cash flows. Since accounting records are normally computerised, this is a fairly simple matter. Nevertheless, very few businesses adopt the direct method.

### *The indirect method*

The indirect method is a much more popular approach. It relies on the fact that, sooner or later, sales revenue gives rise to cash inflows and expenses give rise to outflows. This means that the figure for profit for the year will be linked to the net cash flows from operating activities. Since businesses have to produce an income statement, the information that it contains can be used as a starting point to deduce the cash flows from operating activities.

With credit sales, the cash receipt arises at some point after the sale is made. Thus, sales made towards the end of the current reporting period may result in the cash being received after the end of the period. The income statement for the current period will include all sales revenue generated during that period. Where cash relating to those sales is received after the end of the period, it will be included in the statement of cash flows for the following period.

Profit for the period will not normally equal the net cash inflows from operating activities; in fact they may be quite different. There is, however, a clear link between them. This means that we can deduce the cash inflows from sales if we have the relevant income statement and statements of financial position.

## Activity 5.6

**What information contained within the income statement and statement of financial position for a business can help us deduce the cash inflows from sales?**

The income statement tells us the sales revenue figure. The statement of financial position will tell us how much was owed in respect of credit sales at the beginning and end of the reporting period (trade receivables).

If we adjust the sales revenue figure by the increase or decrease in trade receivables over the period, we deduce the cash from sales for the period. Example 5.1 shows how this is done.

## Example 5.1

The sales revenue figure for a business for the year was £34 million. The trade receivables totalled £4 million at the beginning of the year but had increased to £5 million by the end of the year.

Basically, the trade receivables figure is dictated by sales revenue and cash receipts. It is increased when a sale is made and decreased when cash is received from a credit customer. If, over the year, the sales revenue and the cash receipts had been equal, the beginning-of-year and end-of-year trade receivables figures would have been equal. Since the trade receivables figure increased, it must mean that less cash was received than sales revenues were made. In fact, the cash receipts from sales must have been £33 million (that is, (34 − (5 − 4))).

Put slightly differently, we can say that as a result of sales, assets of £34 million flowed into the business. If £1 million of this went to increasing the asset of trade receivables, this leaves only £33 million that went to increase cash.

The same general point is true in respect of nearly all of the other items that are taken into account in deducing the operating profit figure. The main exception is depreciation. This expense is not normally associated with any movement in cash during that same period.

All of this means that we can take the *profit before taxation* (that is, the profit after interest but before taxation) for the year, add back the depreciation and interest expense charged in arriving at that profit, and adjust this total by movements in inventories, trade (and other) receivables and payables. If we then go on to deduct payments made during the reporting period for taxation, interest on borrowings and dividends, we have the net cash from operating activities.

Example 5.2 illustrates this process.

## Example 5.2

The relevant information from the financial statements of Dido plc for last year is as follows:

| | £m |
|---|---|
| Profit before taxation (after interest) | 122 |
| Depreciation charged in arriving at profit before taxation | 34 |
| Interest expense | 6 |
| At the beginning of the year: | |
| Inventories | 15 |
| Trade receivables | 24 |
| Trade payables | 18 |
| At the end of the year: | |
| Inventories | 17 |
| Trade receivables | 21 |
| Trade payables | 19 |

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