



Accounting For Decision Making

Topic 2
Cash Flows & Annual Reports



Cash vs. Accrual Accounting

 The income statement and balance sheet are based on an accrual system,

• ...which focuses on when a transaction takes place, not when the payment for the transaction occurs





Accrual Accounting

- · Accrual accounting allows for:
 - income not received in cash (e.g. debtors/accounts receivable)
 - income received in advance e.g. prepaid grants
 - expenses not paid in cash (e.g. depreciation, long service leave)
 - expenses paid in arrears (creditors/accounts payable)



- expenses paid in advance (insurance).



Concept of a cash flow statement

Simplified Demonstration:

Bank Balance 1 Jan	\$6,500
Bank Balance 31 Dec	\$7,300
Increase in Net Worth	\$800

HOWEVER.....





Bank Account FLOW is much more revealing

TOTAL CREDITS \$53,900 TOTAL DEBITS \$53,100

The individual had ACCESS to \$6,500 + \$53,900 = \$60,400

....and USED \$53,100





It would be more informative to know how the CHANGES occurred

Inflows:

 Salary
 \$34,300

 Sale of Vehicle
 \$10,800

 Interest
 \$4,500

 Social Security
 \$2,300

 Lottery Win
 \$2,000

 \$53,900





Outflows.

Housekeeping	\$2	23,200
Superannuation	\$	6,000
Purchase Investment	\$	4,000
Mortgage Loan	\$1	2,000
Purchase Furniture	\$	5,900
Vacations	\$	2,000
	\$5	53,100





Importance of cash

DEntities can be quite profitable yet still fail due to poor cash management techniques

(WHY?)

□ An entity needs to ensure it has enough cash on hand to meet its financial commitments in a timely fashion (e.g. workers don't like waiting to be paid their wages)





Importance of cash

Alexandra Clare Hair Care Products Income statement for the month of March 2008		
Income		\$20000
Expenses		
Cost of goods sold (inventory)	\$5600	
Rent	1000	
Wages	4000	
Depreciation	1500	12100
Net profit		\$ 7900

Alexandra Clare Hair Care Products Cash flow statement for the month of March 2008 \$ 2000 Beginning cash balance Operating activities Receipts from sales \$ 5000 Payments for inventory \$6000 Payments for rent 1000 Payments for wages 4000 11000 Net cash flows from operating activities (6000)Closing cash balance (\$4000)





Disadvantages of having too much cash on hand

- There are costs involved in this:
- ☐ May have to pay unnecessary interest to bank for long-term loans
- ☐ Missed investment opportunities indication that management cannot find worthwhile investment projects

So the trick is to have an equilibrium of cash to commitments





The Cash Flow Statement

A cash flow statement shows:

□what money came in (cash inflows)
e.g. sales receipts, loans

□what money went out (cash outflows)
e.g. wages, electricity.

The difference between the two is called net cash flow.





Definition of Cash

□ Cash

- Notes and coins held
- Demand deposit held at financial institutions

□ Cash equivalents

- Highly liquid investments, easily converted to cash with short periods to maturity with little risk of a change in value (e.g. Bank bills, deposit on short-term money market)
- **U**

Bank overdrafts, payable on demand



Relationship to other financial reports

□ A cash flow statement provides users information on the actual cash receipts, cash payments and the net changes in cash during a period, NOT the timing of the underlying transaction

□ Income statement and balance sheet are based on an accrual system, which focuses on when a transaction takes place, not when the payment for the transaction occurs.





Relationship to other financial reports (cont.)

- □ Cash is an entity's most liquid asset and it is an integral component in assessing an entity's financial position
- The cash flow statement gives additional information to assess an entity's ability to generate cash flows, meet its financial commitments, fund changes of its activities, obtain external finance, etc.



□ Together, IS, BS and CFS provide users with information on an entity's: profitability, liquidity, solvency.



Format of the Cash Flow Statement

The Cash Flow Statement contains:

- *net cash flows from operating activities
- *net cash flows from investing activities
- net cash flows from financing activities
- □total net cash flow (increase or decrease in cash held for the period)
- ☐ the beginning cash balance
- The ending cash balance
- comparative figures from the previous year.





Example of a Cash Flow Statement

XXX Ltd

Cash Flow Statement

For the Year Ended 30 June 2013

Cash flows from operating activities:

Cash received from customers	\$ 590,000
Payments to suppliers and employees	(410,000)
Net cash from operating activities	\$180,000

Cash flows from investing activities:

Purchase of equipment	<u>\$(140,000)</u>
Net cash used in investing activities	(140,000)

\$ (50,000)

\$ 94,000

Cash flows from financing activities:

Cash balance, ending

Payment of dividends

Tay mont of arriadias	<u>Ψ (50,000</u>)
Net cash used in financing activities	(50,000)
Net decrease in cash	\$ (10,000)
Cash balance, beginning	\$ 104,000





OPERATING

Cash Received from Customers

less

Cash paid to suppliers for goods & services

equals

Cash flow from Operating Activities

INVESTING

Cash Received from sale on fixed assets & securities

less

Cash paid for securities & assets

equals

Cash flow from Investing Activities

WHICH SUM TO:

Net Increase/ Decrease in Cash on Hand

FINANCING

Cash Received from issue of Shares/Debt

less

Dividends paid or cash paid to redeem shares/debt

equals

Cash flow from Financing Activities



CASH FLOW STATEMENT

\$

10,000

(20,000)\$(10,000)

\$12,000

\$25,000

13,000

CASH FLOWS RELATED TO OPERATING ACTIVITIES	
Receipts from customers	365,000
Payments to suppliers	(264,000)
Payments to employees	(47,000)
Payments for expenses	(24,000)
Income taxes paid	(11,000)
NET OPERATING CASH FLOWS	<i>\$19,000</i>
CASH FLOWS RELATED TO INVESTING ACTIVITIES	
Cash paid for the purchase of equipment	(32,000)
	25 222

NET OPERATING CASH FLOWS	<u>\$19,000</u>
CASH FLOWS RELATED TO INVESTING ACTIVITIES	
Cash paid for the purchase of equipment	(32,000)
Cash proceeds from the sale of property	<u>35,000</u>
NET INVESTING CASH FLOWS	\$ 3,000

CASH FLOWS RELATED TO FINANCING ACTIVITIES

Cash proceeds from the issue of shares

NET INCREASE (DECREASE) IN CASH HELD

NET FINANCING CASH FLOWS

Repayment of borrowings

Cash at the beginning of year

CASH AT END OF YEAR



Operating Activities

Operating activities — day to day activities that relate to the provision of goods/services, and other activities not included in investing or financing activities

Examples:

- Receipts from customers (sell goods/services)
- Payments to suppliers and employees (purchase goods/services, pay salaries)
- Other payments for expenses and receipts for income (e.g. tax expense)



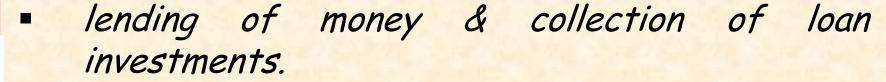


Investing Activities

... activities which relate to the acquisition and/or disposal of *non-current assets*, and *investments* ~ primarily reflected in the non-current assets section of the balance sheet...

Examples:

- purchase & sale of property, plant & equipment
- purchase & sale of share investments







Financing Activities

Financing activities — activities which relate to changing the size and/or composition of the financial structure of the entity ~ primarily reflected in the equity and non-current liabilities sections of the balance sheet...

Examples:

- Cash received from the issue of shares or debt
- Cash paid to shareholders or to repay debt





Some areas of grey ...

Note: AASB 107

para 33....Interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss.

Alternatively,

interest paid and interest and dividends received may be classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments.





Some (more) areas of grey ...

Note: AASB 107

para 34 Dividends paid may be classified as a financing cash flow because they are a cost of obtaining financial resources.

Alternatively,

dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows.





Example:



- a. Payment of income taxes
- b. Cash lent to borrowers
- c. Payment of the electricity account
- d. Money received from a customer
- e. The purchase for cash of some equipment
- f. The payment of a long-term liability
- g. The receipt of dividends
- h. Payment of interest
- i. The receipt of money from a newly acquired loan





Solutions



- b. Investing
- c. Operating
- d. Operating
- e. Investing
- f. Financing
- g. Operating (or investing)
- h. Operating (or financing)
- i. Financing







ABC company:

- 1. purchased equipment at cost of 98,000
- 2. paid cash dividends of 18,000
- 3. issued ordinary shares for cash at \$26,000
- 4. repaid loan of 5,000
- 5. paid tax 7,000.
- 6. sold products for 20,000 (cost price is 15,000).
- 7. sold building for 74,000
- 8. purchased long-term investment of 8,000.



What are cash flows from investing activities and financing activities?





Cash flows from investing activities:

Net cash from investing activities	(32,000)
Purchase of long-term investment	(8,000)
Sale of building	74,000
Purchase of equipment	(98,000)

Cash flows from financing activities:

(18,000)
26,000
(5,000)
3,000





Example: Preparing a Cash Flow statement

Preparing a cash flow statement for Hale Pty Ltd for the year ended 31 December 2013.





Cash paid to purchase equipment

Cash paid for interest

12 310 → investing

4 231 -> operating (or

financing)



Bits Ltd and Pieces Ltd Comparative Statements of Cash Flows for the year ended 31st December 2013

	Bits Ltd.	Pieces Ltd
Cash Flows from Operating Activities	\$ 77,100	\$ (81,600)
Cash Flows from Investing Activities	(441,000)	(150,750)
Cash Flows from Financing Activities	217,500	82,500
Net increase (decrease) in cash held	(146,400)	(149,850)
Cash at Beginning	183,900	(74,700)
Cash at End	\$37,500	\$(224,550)

What does this comparison say about the relative cash flow performance of these entities?





'Eyeballing' cash flow statements

Cash flow warning signals include:

- ☐ Cash received < cash paid (net decrease)
- Operating outflow (negative cash flows from operations)
- ☐ Cash receipts from customers < cash payments to suppliers and employees
- □ Substantial difference between operating cash flows and net profit





'Eyeballing' cash flow statements

☐Proceeds of share capital are used to finance operating activities

□Inflows from investing activities are inconsistent (e.g. selling off major assets to pay debts)

□ Proceeds from loans are continually less than repayment of borrowings.





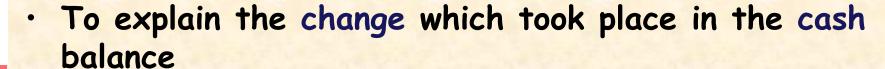
Uses of Statement of Cash Flows

- The information provided in the statement of cash flows together with other information in the accounts may assist in assessing the ability of an entity to:
- · Generate positive net cash flows in the future;
- Meet its financial commitments as they fall due, including the servicing of borrowings and the payment of dividends;
- Fund changes in the scope and/or nature of its activities; and



· Obtain external finance where necessary.





- To explain the effects of operating activities on the cash balance
- · To explain the effects of investing and financing activities on the cash balance
- To evaluate the possible effects of non-cash transactions and events disclosed in notes on future cash flows
- To evaluate the statement of cash flows for the current period against those of previous years in terms of trends revealed in the previous four items





Summary

- · Three key financial reports:
 - Income Statement Performance over last 12 months
 - Balance Sheet Net worth at a point in time
 - Cash Flow Statement Where cash has been generated and used
- · However...
- Don't overstate the importance of financial management!!!





Next session ~ cases...

Case 1-2 Kim Fuller

Case 13.3 Identify the Industries

Case 13.4 Supplement to Identify the Industries



Case 17.3: Shelter Partnership Inc