



UniSA

BUSINESS
ENTERPRISE

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	<u>\$ 2,000</u>
	\$53,900

Outflows:

Housekeeping	\$23,200
Superannuation	\$ 6,000
Purchase Investment	\$ 4,000
Mortgage Loan	\$12,000
Purchase Furniture	\$ 5,900
Vacations	<u>\$ 2,000</u>
	\$53,100

Importance of cash

- ❑ Entities 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		\$20 000
Expenses		
Cost of goods sold (inventory)	\$5 600	
Rent	1 000	
Wages	4 000	
Depreciation	1 500	12 100
Net profit		\$ 7 900

Alexandra Clare Hair Care Products Cash flow statement for the month of March 2008

Beginning cash balance		\$ 2 000
Operating activities		
Receipts from sales		\$ 5 000
Payments for inventory	\$6 000	
Payments for rent	1 000	
Payments for wages	4 000	11 000
Net cash flows from operating activities		(6 000)
Closing cash balance		(\$4 000)

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 - an 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)
- 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	<u>(410,000)</u>
<i>Net cash from operating activities</i>	<i>\$180,000</i>

Cash flows from investing activities:

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

Cash flows from financing activities:

Payment of dividends	<u>\$ (50,000)</u>
<i>Net cash used in financing activities</i>	<i><u>(50,000)</u></i>

Net decrease in cash	\$ (10,000)
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Cash balance, beginning	\$ <u>104,000</u>
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Cash balance, ending	\$ <u>94,000</u>
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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**

FINANCING

**Cash Received
from issue of
Shares/Debt**

less

**Dividends paid
or cash paid to
redeem
shares/debt**

equals

**Cash flow from
Financing
Activities**

**WHICH SUM TO:
Net Increase/ Decrease in
Cash on Hand**

CASH FLOW STATEMENT

\$

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	<u>(11,000)</u>
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	<u>\$ 3,000</u>

CASH FLOWS RELATED TO FINANCING ACTIVITIES

Cash proceeds from the issue of shares	10,000
Repayment of borrowings	<u>(20,000)</u>
NET FINANCING CASH FLOWS	<u>\$(10,000)</u>

NET INCREASE (DECREASE) IN CASH HELD

Cash at the beginning of year	13,000
CASH AT END OF YEAR	<u>\$25,000</u>

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*
- *lending of money & collection of loan 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:

For each of the items listed below, classify the cash flows into **operating**, **investing** or **financing** activities

- 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

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

Example

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?*

Solutions

Cash flows from investing activities:

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

Cash flows from financing activities:

Payment of cash dividends	(18,000)
Issue of ordinary shares	26,000
Repayment of loans	<u>(5,000)</u>
<i>Net cash from financing activities</i>	<i>3,000</i>

Example: Preparing a Cash Flow statement

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

Cash balance, 31 December 2013	\$51 618 →end balance
Cash paid to employees and suppliers	220 013 →operating
Cash received from sale of land	38 079 →investing
Cash paid as income taxes	16 924 →operating
Cash received from debentures	25 386 →financing
Cash paid to purchase truck	30 000 →investing
Cash balance, 1 January 2013	38 925 →beg. balance
Cash paid as dividends	53 311 →financing
Cash received from customers	279 247 →operating
Cash received as interest	6 770 →operating (or investing)
Cash paid for interest	4 231 →operating (or financing)
Cash paid to purchase equipment	12 310 → investing

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	<u>217,500</u>	<u>82,500</u>
Net increase (decrease) in cash held	(146,400)	(149,850)
Cash at Beginning	<u>183,900</u>	<u>(74,700)</u>
Cash at End	<u>\$37,500</u>	<u>\$(224,550)</u>

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 **change** which took place in the **cash balance**
- 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