Chapter 16
The cash flow statement

Learning objectives
- Describe the purposes of the cash flow statement
- Report cash flows from operating, investing and financing activities
- Differentiate between the direct and indirect method for reporting cash flows
- Prepare a cash flow statement by the direct method
- Calculate the cash effects of a wide variety of business transactions
- Prepare a cash flow statement by the indirect method
- Summarise supplementary disclosures required by accounting standards
- Analyse cash flows for decision making

Introduction: The cash flow statement
- The cash flow statement reports cash flows, namely cash receipts and cash payments
- It shows where cash came from (receipts) and how cash was spent (payments)
- It reports why cash increased or decreased during the period
- It covers a span of time and is dated the same as the income statement
- The statement of cash flows explains why profit as reported on the income statement does not equal the change in the cash balance
- It includes cash and cash equivalents, which are liquid short-term investments that can be converted into cash at will
Introduction: The cash flow statement

Operating, investing and financing activities

- The cash flow statement shows how cash receipts and payments are divided into operating activities, investing activities and financing activities
- Operating activities are related to the transactions that make up profit
- Investing activities relate to the long-term asset accounts
- Financing activities relate to the non-current liability accounts and the owners’ equity accounts
Format of the cash flow statement

- There are two formats for reporting cash flows from operating activities, namely the direct method and the indirect method.
- The direct method lists cash receipts from specific operating activities and cash payments for each major operating activity.
- The indirect method starts with profit and reconciles to cash flows from operating activities.
- AASB 107 allows companies to use either the direct method or the indirect method.
- If the direct method is used, AASB 107 requires disclosure in a note showing the reconciliation of cash flows from operating activities to profit.

Preparing the cash flow statement by the direct method

**Step 1:** Identify the activities that increased or decreased cash.

**Step 2:** Classify each cash increase and each cash decrease as an operating activity, an investing activity or a financing activity.

**Step 3:** Identify the cash effect of each transaction.
Preparing the cash flow statement by the direct method

- Operating cash flows are listed first because they are the most important source of cash for most businesses.
- The failure of operations to generate the bulk of cash inflows for an extended period will signal trouble for a company.
- Investing activities are important because a company’s investments determine its future.
- Purchases of non-current assets signal expansion.
- Low levels of investing activities indicate that the business is not replenishing its assets.
- Cash flows from financing activities include several specific items. All are related to obtaining money from investors and lenders and paying them back.

Calculating individual amounts for the cash flow statement

Revenue or expense from the income statement + Adjusted for the change in the related account(s) from the balance sheet = Amount for the statement of cash flows

Calculating the cash amounts of operating activities
Calculating the cash amounts of operating activities

Calculating the cash amounts of investing activities

Calculating the cash amounts of financing activities
Preparing the cash flow statement by the indirect method

• This method starts with profit from the income statement and reconciles to operating cash flows
• It shows the link between profit and cash flow from operations better than the direct method
• The main drawback of the indirect method is that it does not report the detailed operating cash flows
• These two methods (direct and indirect) of preparing the cash flow statement affect only the operating activities section of the statement
• No difference exists for investing or financing activities

Preparing the cash flow statement by the indirect method

• The indirect-method cash flow statement begins with profit from the income statement
• Additions and subtractions follow
• These are labelled ‘Add (subtract) [items that affect profit and cash flows differently]’
Preparing the cash flow statement by the indirect method

- All expenses with no cash effects are added back to net profit on the cash flow statement
- Revenues that do not provide cash are subtracted from net profit
- An increase in a current asset other than cash is subtracted from profit to calculate cash flow from operations
- A decrease in a current asset other than cash is added to profit
- A decrease in a current liability is subtracted from profit
- An increase in a current liability is added to profit

Supplementary disclosures

- Supplementary disclosures are required in the notes accompanying cash flow statements prepared in accordance with AASB 107
- The first disclosure provides a reconciliation of cash as used in the cash flow statement with related items from the balance sheet
- Where the direct method is used, AASB 107 requires disclosure in a note of a reconciliation of cash flows from operating activities to profit
- Disclosure is also required of transactions and other events not resulting in cash flows but which affect assets and liabilities. Such transactions and events are referred to as non-cash financing and investing activities
Measuring cash adequacy: Free cash flow

Free cash flow

Net cash provided by operating activities

Cash payments to acquire plant and equipment

Cash dividends

Using cash flow information in investment and credit analysis

- Cash flows are important to a company’s survival
- A cash shortage is usually the most pressing problem of a struggling organisation
- Abundant cash allows a company to expand, invest in research and development and hire the best employees

Summary: Chapter 16

- The cash flow statement reports cash flows, namely cash receipts and cash payments
- It highlights operating activities, investing activities and financing activities
- It can be prepared using the direct method or the indirect method
- If the direct method is used, AASB 107 requires disclosure in a note showing the reconciliation of cash flows from operating activities to profit
- Cash flows are important to a company’s survival