Preparation Of The Statement Of Cash Flows In Accordance With IAS 7

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Abstract: International Accounting Standard (IAS) 1: *Presentation of financial statements*, stipulates that the statement of cash flows is one of the primary annual financial statements to be prepared by every entity using the international financial reporting standards (IFRS). It should be given equal prominence as the other financial statements. This is a very important statement as it shows how much cash was generated from what sources and how that cash was utilised. IAS 7 *Statement of cash flows* details the provisions for the preparation of this very important statement. The amounts required in the preparation of this statements are not readily available from the financial accounts, and have to be calculated from the financial information available. The purpose of this article is to provide a step by step explanation regarding the preparation of the statement of cash flows. Both the direct and indirect methods are explained in some detail. It is hoped that both students and practitioners will befit from this exposition.

Key words: accounting standards, cash and cash equivalents, cash flows, financing activities, investing activities, operating activities, statement of financial position.

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Preparation of the statement of cash flows in accordance with IAS 7

The statement of cash flows is one of the financial statements required to be prepared by an entity in terms of IAS 1 Presentation of financial statements.

Cash is a very important asset in any entity. In fact it has been described as the lifeblood of an entity. Without sufficient cash to pay its obligations as they fall due, an entity may become insolvent and be liquidated. It is also useful in the following ways:

- It enables users to evaluate the liquidity or solvency of an entity
- It enhances comparability of operating performance by different entities, because it eliminates the effects of using different accounting treatment to the same events and transactions.
- Historical cash flow information can be used to indicate the amount and timing of future cash flows.

The statement summarises cash inflows and cash outflows during a specific reporting period. The standard requires that this information be presented under the following 3 headings:

Cash flows from operations
Cash flows from investments
Cash flows from financing

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Definitions

The following definitions given in the standard are important.

Cash - Cash in hand and demand deposits

Cash Equivalents - Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Operating Activities - The principal revenue- producing activities of the entity and other activities that are not investing or financing activities

Investing Activities - The acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing Activities - Activities that result in changes in the size and composition of the contributed equity and borrowings of an entity.

Abbreviations used

SOCI **-** Statement of comprehensive income
SOFP **-** Statement of financial position

Steps in the preparation of the statement of cash flows

The standard allows two methods of presenting the operating activities section of the statement, namely, the direct method and the indirect method. We will start by discussing the indirect method, which is the more widely used of the two.

The indirect method.

With this method, you start with the net profit after interest, but before tax. In order to arrive at the cash generated from operations, it is necessary to make the following adjustments to this net profit figure:

1. Reversal of all non cash items included in the statement of comprehensive income (e.g. depreciation or profit on disposal of noncurrent assets)
2. Reversal of interest provided during the year

3. Adjustment for working capital items (i.e. movements in current assets and current liabilities during the year.)
4. Calculate the actual amounts paid in respect of interest, tax and dividends.

The following illustrates the nature of items commonly found on this section of the statement:

Note	Item	Amount	Amount
	Net profit before tax		xxxx
1	Add/ Less ( ) noncash items		
	Depreciation	xxxx	
	Profit on sale of non current assets	(xxxx)	
	Loss on sale of non current assets	xxxx	
2	Reversal of interest provided during the year.	xxxx	
3	Working capital adjustments		
	Increase in current assets	(xxxx)	
	Decrease in current assets	xxxx	
	Increase in current liabilities	xxxx	
	Decrease in current liabilities	(xxxx)	
4	Interest paid	(xxxx)	
	Tax paid	(xxxx)	
	Dividends paid	(xxxx)	
			xxxx
	Net cash flow from operating activities		xxxx

Explanations

Note 1

When reversing noncash items, debits to the SOCI are added back and credits are deducted. Thus, depreciation , which is a charge to the SOCI is added back.

Note 2

This is the interest that was provided in the SOCI during the current year. However we are interested in the amount of interest actually paid , so we reverse the provision by adding it back. The amount actually paid is calculated as per note 4.

Note 3

Working capital adjustment

This adjustment is necessary to determine the amounts of cash flows relating to current assets and current liabilities during the reporting period. It involves the comparison of figures on the previous and current SOFPs for each item, to determine if there was an increase or decrease on the respective items. Be guided by the following:

a) An increase in a current asset (e.g. inventory) means cash was paid to buy more of that asset, and represents an outflow of cash. Conversely, a decrease represents a cash inflow.
b) A decrease in a current liability means the liability was reduced by a cash payment., and therefore represents an outflow of cash. Conversely, an increase represents an inflow of cash.

Note 4

Actual amounts paid in respect of interest, tax or dividends The easiest way of determining the actual amounts payout is by using the T account (i.e. reconstructing the relevant account using figures on the SOFP and SOCI and SOFP). This is illustrated below:

Interest payable account			
Cash paid (Balancing figure)	xxxx	Balance b/d (SOFP previous year)	xxxx
Balance c/d (SOFP current year)	xxxx	Current provision (SOCI current year)	xxxx
	xxxx		xxxx
		Balance b/d	xxxx

Explanation

The opening balance is taken from the SOFP of the previous year, i.e. it is the amount owing at the beginning of the current year. The current provision is taken from the SOCI of the current year (Dr SOCI and Cr Interest payable). The balance c/d is the amount appearing on the current year SOFP. The balancing figure is the cash paid out (highlighted in bold.).

The direct method.

In this method, cash flows are reported in terms of major classes of gross receipts and gross payments. Typically, these will include receipts from customers, payments to suppliers of goods and services, and payments to employees. These are usually reported under the following headings:

Cash receipts from customers
Cash paid to suppliers
Cash paid to employees
Cash paid for other operating expenses
Interest paid

In most cases, these amounts are not readily available, and will have to be calculated from the available information. Again the easiest way of determining these figures is by using the T account to get the missing figure. When calculating the amount received from customers, one would use the following T account;

Debtors account			
Balance b/d (SOFP previous year)	xxxx	**Receipts from customers (balancing figure)**	xxxx
Sales (SOCI current year)	xxxx	Balance c/d (SOFP current year).	xxxx
Balance b/d	xxxx		

Alternatively, the following formula is used: Receipts from customers = Opening debtors + sales - closing debtors

Using the T account to calculate payments to creditors is illustrated below:

Creditors account			
Cash paid to creditors (balancing figure)	xxxx	Balance b/d (SOFP previous year)	xxxx
Balance c/d (SOFP current year)	xxxx	Purchases (SOCI current year)	xxxx
	xxxx		xxxx
		Balance b/d	xxxx

Alternatively, the following formula can be used: Payments to creditors = opening creditors + purchases - closing creditors. The same method , i.e. using a T account can be used when calculating the amounts paid to employees as well as other expenses. The following formula can also be used: Amount paid = Operating expenses (shown on SOCI) + increase in prepaid expenses (- decrease in prepaid expenses) + decrease in accrued expenses (- increase in accrued expenses). The following example illustrates the practical application of these steps in the preparation of the statement of cash flows.

Example.
The following are financial statements of Kuchi Ltd for the year ended 31 December 2012

Statement of comprehensive income for the year ended 31 December 2012

Revenue		900 000
Cost of sales		475 000
Gross profit		425 000
Less		
Operating expenses	220 000	
Interest	13 000	
Loss on sale of equipment	2 000	
		(235 000)
Net profit before tax		190 000
Tax		65 000
Net profit after tax		125 000

Statement of financial position as at 31 December 2012

	2012		2011	
Non current assets				
Land		55 000		80 000
Buildings	200 000		200000	
Less depreciation	20 000		10 000	
		180 000		190 000
Equipment	183 000		58 000	
Less depreciation	28 000		10 000	
		155 000		48 000
		390 000		318 000
Current assets				
Stock	50 000		0	
Prepaid expenses	3 000		5 000	
Debtors	67 000		25 000	
Cash	55 000		38 000	
		175 000		68 000
		565 000		386 000
Equity and liabilities				
Ordinary share capital		230 000		70 000
Retained income		196 000		126 000
		426 000		196 000
Non current liabilities				
Debentures		106 000		150 000
Current liabilities				
Creditors		33 000		40 000
		565 000		386 000

You are given the following additional information:

1. Depreciation amounting to $33 000 and amortisation of prepaid expenses of $2 000 are included in operating expenses .
2. Equipment that cost $41 000, with a book value of $36000 was sold for $34 000
3. Dividends of $55 000 were declared and paid during the year .

Required
Prepare the statement of cash flows for Kuchi Ltd for the year ended 31 December 2012.

Solution
The first part of the solution shows the operating activities section only,(there is no change in the other two sections, whatever method is being used) using the direct method. The second part shows the full statement of cash flows for the year.

Using the direct method - operating activities section only

Statement of cash flows for the year ended 31 December 2012.

	Note	$	$
Operating activities			
Cash received from customers	1		858 000
Payments to suppliers of goods	2	(532 000)	
Payments to other creditors	3	(185 000)	
Interest paid	4	(13 000)	
Tax paid	5	(65 000)	
			(795 000)
Cash flow from operating activities			63 000

Workings

Note 1
Cash received from customers = opening debtors + sales - closing debtors.

= 25 000 +900 000 - 67 000 = 858 000

Note 2
Payments to suppliers of goods = opening creditors + purchases - closing creditors

= 40 000 + 525000 - 33 000 = 532 000

NB. Use the following formula to calculate the purchases figure

Cost of sales = opening stock + purchases - closing stock
Therefore: purchases = cost of sales + closing stock - opening stock

= 475 000 + 50 000 - 0 = 525 000

Note 3
Payments to other creditors and suppliers = operating expenses - depreciation - decrease in prepaid expenses

= 220 000 - 33 000 - 2 000 = 185 000

Notes 4 and 5
For these two items, there is nothing outstanding at the beginning of the year, as well as at the end of the year. So it means that the amounts provided during the year were all paid out.

Using the indirect method - all sections

Statement of cash flows for the year ended 31 December 2012.

	$	$
Operating activities		
Net profit before tax		190 000
Add		
Depreciation (given)	33 000	
Loss on sale of equipment (given)	2 000	
Decrease in prepaid expenses (5 000 - 3000)	2 000	
Less		
Increase in stock (50 000 - 0)	(50 000)	
Increase in debtors (67 000 - 25 000)	(42 000)	
Decrease in creditors (40 000 - 33 000)	(7 000)	
		(62 000)
		128 000
Less tax paid (given)		(65 000)
Cash flow from operating activities		63 000
Investment activities		
Sale of land - cash proceeds (80 000 - 55 000)	25 000	
Sale of equipment - cash proceeds (given)	34 000	
Purchase of equipment (note 6)	(166 000)	
Net cash flow from investment activities		(107 000)
Financing activities		
Issue of shares (230 000 - 70 000)	160 000	
Redemption of debentures (150 000 - 106 000)	(44 000)	
Dividends paid (given)	(55 000)	
Net cash flow from financing activities		61 000
Net cash flow for the year		**17 000**
Cash at the beginning of the year (2011 statement of financial position)		38 000
Cash at the end of the year (2012 statement of financial position)		**55 000**

Workings

Note 6
The T account can be used to determine the equipment purchased during the year, as illustrated below:

Equipment account			
Balance b/d (SOFP 2011)	58 000	Asset disposal (given)	41 000
Cash (balancing figure)	***166 000***	Balance c/d (SOFP 2012)	183 000
	224 000		224 000
Balance b/d	183 000		

Recommended for further reading

The following are recommended for further reading:

IAS 1 Presentation of financial statements: IFAC

IAS 7 Cash flow statement: IFAC

ACCA F7 2012 Study text: Financial reporting by Emile Woolf LTD

The Institute of Chartered Accountants of England and Wales (ICAEW): International financial reporting standards: Certificate learning materials. ICAEW.

Tiffin, R. (2010) The complete guide to international financial reporting standards including ias and interpretation. London: Thorogood

Van Greuning H. (2006) International financial reporting standards: a practical guide. Washington DC: World bank.