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IAS® Standard 7 Cash Flow Statement

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IAS® Standard 7 Statement of Cash Flows

SCOPE AND KEY DEFINITIONS

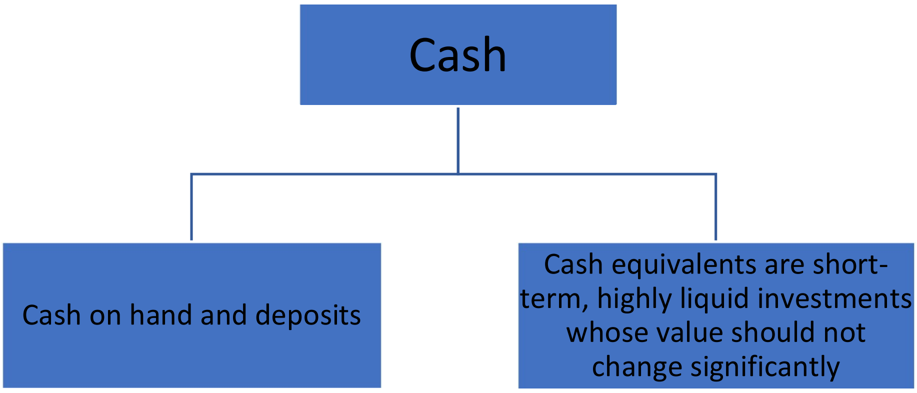
IAS Standard 7 Statement of Cash Flows provides the requirements that an entity should follow when preparing and presenting a statement of cash flows, as part of its complete set of financial statements presented for each period, together with a statement of financial position, a statement of profit or loss and other comprehensive income, a statement of changes in equity for the period, and the notes to the financial statements.

Information about the entity's cash flows is fundamental for external users in assessing the entity's evolution and its prospects. As a fundamental principle underlying accrual accounting, cash is different from profit. Therefore, users will find it useful and relevant to be provided with information about an entity's financial position, profit and cash, as different sides of the same business story. Cash information allows users to assess an entity's financial structure (particularly its liquidity and solvency) and ability to adapt to, and benefit from, future challenges and opportunities. Presented consistently over time, such information also enhances the comparability of information over time and space, as it should eliminate the effect of using different methods for similar events, that is characteristic of the other two important financial statements (the statement of financial position and the statement of profit or loss and other comprehensive income).

$$Cash \neq Profit$$

Cash flows refer to inflows and outflows of cash and cash equivalents (IAS7.6) (Figure 1).

Figure 1. Cash and cash equivalents



The statement of cash flows presents the changes in cash and cash equivalents during an accounting period. The amount of cash reported in the statement of financial position is not enough to external users because it may result from divesting activities, or unsustainable borrowings or repayment of loans granted. And, in any case, a single figure is not able to explain the underlying causes and assist in forecasting the evolution of an item. Additionally, profit or loss for the period is impacted by the manifold choices management make to represent events and transactions, and by the effect of accrual accounting (such as revenue recognition, asset depreciation or impairment, provisions and so forth). A cash flow report is thus useful in giving a complete picture of the entity's position. Table 1 provides the general format of a statement of cash flows.

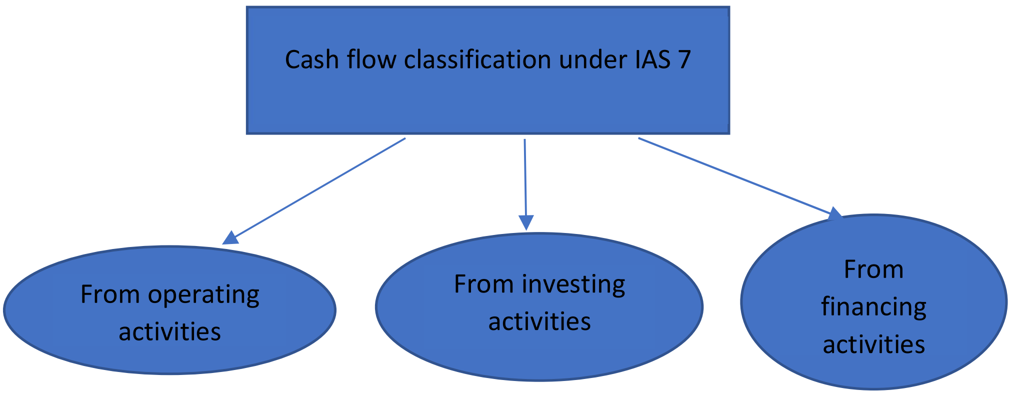
Table 1. The format of the statement of cash flows

Statement of cash flows for the year N	
Cash flows from operating activities	X(X)
Cash flows from investing activities	X(X)
Cash flow from financing activities	X(X)
Net increase/ (decrease) in cash and cash equivalents during period	**X(X)**
Cash and cash equivalents at the beginning of the period	**X(X)**
Cash and cash equivalents at the end of the period	**X(X)**

PRESENTATION OF THE STATEMENT OF CASH FLOWS

Cash flows should be presented as arising from operating, investing, or financing activities. These activities are defined as follows (IAS7.6) (see Figure 2):

Figure 2. Cash flow classification



- Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
- Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
- Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. Table 2 provides examples of cash flows included in each activity.

Table 2. Classification of cash flows

Cash flow activity/type	Cash inflows arising from	Cash outflows
Operating activities	● the sale of goods or the rendering of services ● royalties, fees, commissions, and other revenue ● dividends and interest received, unless they are presented in investing activities	● to suppliers for goods and services purchased ● to employees ● of income taxes, unless they are identified with financing and investing activities ● of dividends and interest paid, unless they are presented in financing activities
Investing activities	● the sale of long-term assets (such as property, plant and equipment, or intangibles) ● the sale of equity or debt instruments of other entities (i.e., shares or bonds) ● the repayment of loans granted to other parties ● dividends and interest received, unless they are presented in operating activities	● to suppliers of long-term assets (such as property, plant and equipment, or intangibles) ● to acquire equity or debt instruments ● from loans granted to other parties
Financing activities	● issuing shares or other equity instruments ● from borrowings	● to owners to acquire or redeem the entity's shares ● for the repayment of loans borrowed principal ● to dividends and interest paid, unless they are presented in operating activities.

A "practical" rule of thumb is that the cash flows resulting from transactions that have a profit or loss effect are presented under the operating activities (so, except for the cash payments of dividends, presented as financing cash flows, the cash effect of other interest and dividend related transactions are operating flows). While the operations of entities vary across various domains, their investing and financing activities are similar; therefore, a residual definition of operating activities as those not being investing or financing may also help in distinguishing between these flows. This rule of thumb is not, however, a requirement by IAS 7, entities being allowed to present these flows as they deem more appropriate to their case. This option may decrease the comparability of financial statements across entities, and users should exercise careful judgment to make meaningful comparisons.

Financial institutions are a separate industry, as their operations are different from those of non-financial entities. Therefore, cash inflows and outflows related to, or resulting from, loans made by such financial institutions, are reported as arising from their operating activities (unlike their non-financial counterparts). Cash payments for interest and cash receipts from interest and dividends are also usually classified as arising from operating activities by financial institutions.

The information on cash flows from operating activities is a key indicator in assessing an entity's ability to generate sufficient cash for conducting general business, but also for reimbursing loans, maintaining its productive capacity, paying dividends, and making investments without relying on external financing sources. A net outflow (or negative cash flow) from operating activities shows a difficult cash position of the entity since the cash receipts from sales may be insufficient for making regular future payments. In such cases, an entity must rely on some external sources of cash (which imply additional costs) or divest (e.g., sell noncurrent assets), which decreases its production capacity. Therefore, a positive cash flow from operating activities is normally expected.

A net inflow from investing activities may indicate some restructuring/disinvesting operations. A negative investing cash flow is a sign of investments in the future of the entity, which should ensure the good functioning of its activities. While a negative cash flow from investing activities is not a worrying sign, a large amount may require attracting additional funds if the operations of the entity are not sufficient to fund these investments.

A net inflow generated by financing activities may indicate that the entity drew on either internal (equity) or external (debt) sources of cash to support a net outflow from operations or to uphold massive investing activities. A positive financing cash flow may entail future large payments for the reimbursement of bank loans, interest or dividends and should, therefore, be taken with a grain of salt.

Example 1 SCF compilation Entity SCF began the year 2022 with cash amounting to CU30,000. During the year 2022, the entity:

- sold finished goods for CU10,000 in cash and for CU50,000 on credit
- purchased raw materials for CU40,000, while only paying CU20,000 to suppliers
- contracted a bank loan for CU35,000
- acquired a machine for CU40,000, and paid it entirely in cash; and
- sold for cash 100 shares issued by another entity for CU10,000.

Prepare the entity's statement of cash flows for the year 2022.

Solution: The entity's statement of cash flows prepared at the end of 2022 is presented in Table 3 below (all amounts in CU):

Table 3. SCF's statement of cash flows

Cash flows from operating activities (all amounts in CU)	
Cash receipts from customers	10,000
- Cash payments made to suppliers	(20,000)
= Net cash flow from operating activities (I)	=(10,000)
Cash flows from investing activities	
Cash receipts from selling shares	10,000
- Cash payments to suppliers of non-current assets	(40,000)
= Net cash flow from investing activities (II)	=(30,000)
Cash flows from financing activities	
Cash received from bank loans	35,000
= Net cash flow from financing activities (III)	=35,000
Total net cash flow (IV) = (I) + (II) + (III)	(5000)
Cash and cash equivalents as of 01.01.2022 (V)	30,000
Cash and cash equivalents as of 31.12.2022 (VI) = (IV) + (V)	25,000

REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

Cash flows from operating activities may be presented using either the direct or the indirect method. The total net cash flow resulting from operating activities is the same, however, regardless of how it is presented. Cash flows from investing and financing activities are always presented by indicating gross cash receipts and payments.

Entities are encouraged to present their operating cash flows using the direct method. According to this method, the gross cash receipts and cash payments are presented. This method is used in Example 1 above.

Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the period for the effects of (IAS7.20):

1) any non-cash income or expense items (e.g., depreciation, impairment),
2) income or expense items resulting in investing or financing cash flows, and
3) changes in inventories, receivables, payables and other operating items.

Expense items that need adjustment will be added to the profit figure, while revenue items that need adjustment will be subtracted, to eliminate their effect. For example, the retreatment of depreciation expense (as a non-cash item) will be done by adding it back to the amount of profit obtained for the year. Impairment reversals recognized in the statement of profit or loss will be deducted from profit or loss to retreat them. All items of profit or loss that need adjustment will be treated in a similar manner.

Income or expense items resulting in investing or financing cash flows refer to items that have cash flow effects, but they are not presented as arising from operating activities. For example, collections arising from divesting activities, or interest expense when interest payments are presented as arising from financing operations.

Finally, the third retreatment refers to what is called the operating working capital; that is, items of assets and liabilities that have a cash flow effect presented as an operating one. Let's say that, for example, an entity sells merchandise on credit in a certain year, for CU2,000. Of this amount, the entity only collects CU1,500 during the year. In other words, the entity's accounts receivables have increased by CU500 during the year as a result of these transactions only. The cash flows from operating activities will be presented as follows according to the two methods (see Table 4). We are assuming that this sale transaction is the only item resulting in profit or loss for the period.

Table 4. Direct and indirect method presentation of cash receipts from customers

Direct method	Indirect method	
Cash receipts from customers CU1,500	Profit or loss	CU2,000
	- increase in accounts receivable	(500)
= Cash flow from operating activities 1,500	=Cash flow from operating activities	1,500

As indicated in Table 4, the CU500 that were not collected in the current period have negatively impacted the period's collections from customers. This reasoning may be extended to all the relevant asset items; as such, any increase in an operating asset will negatively impact the cash flow from operating activities when presented via the indirect method. It should be noted that this does not mean that this amount of cash will not be collected, as we are not inferring anything about the collectability of this asset. This is merely reflective of the different timing of revenue and cash recognition over time. Conversely, a decrease in an operating asset item will positively impact the cash flow from operating activities.

Opposite expectations regard liability items. Let's say that an entity incurs CU3,000 as employee wages in a certain year. The entity only pays part of these wages during the year, in the amount of CU2,700, the balancing figure remaining to be paid the next year (this impacts positively the operating cash flows for this year, by postponing the CU300 payment for the moment). According to the direct method, the cash flows from operating activities will be impacted by a cash payment of CU2,700 to employees in the current year. According to the indirect method, the cash flows from operating activities would be presented by retreating the profit or loss for the period, represented here by the CU3,000 wages expense, for the effect of the CU300 increase in wages payable ((2,700)=(3,000)+300).

Table 5 recapitulates all these rules.

Table 5. Treatment of operating working capital items in presenting cash flows from operating activities (CFO) under the indirect method

	Operating Assets	Operating Liabilities
Increase	Negative impact on CFO	Positive impact on CFO
Decrease	Positive impact on CFO	Negative impact on CFO

Example 2 SCF compilation - Indirect method for cash flows from operating activities

The following items have been extracted from the financial statements of SCF Co. for the year 2022 (all amounts in CU):

Item	**Amount**
Sales	5,000
Cost of goods sold	(2,000)
Wages expense	(1,000)
Depreciation expense	(500)
Profit	1,500

Item	**Opening balances**	**Ending balances**
Accounts receivable	600	100
Inventories	200	1,200
Accounts payable	300	700
Wages payable	600	0

Prepare the entity's statement of cash flows for the year 2022.

Solution:

The cash flow from operating activities will be shown as follows using the two methods:

1) according to the direct method

Item	**Amount (in CU)**
Cash collections from customers*	5,500
-Cash payments to suppliers**	(2,600)
-Cash payments to employees***	(1,600)
=Cash flow from operating activities	1,300

* 5,500	= Sales + opening balance accounts receivable – ending balance accounts receivable	5,500 = 5,000+600-100
**(2,600)	Purchases = cost of goods sold + ending balance inventories - opening balance inventories Then, payments to suppliers = purchases + opening balance accounts payable – ending balance accounts payable	3,000 = 2,000+1,200-200 (2,600) = 300+3,000-700
***(1,600)	Payments to employees = (wages expense + opening balance wages payable – ending balance wages payable)	(1,600) = (1,000+600-0)

2) according to the indirect method

Item	Amount (in CU)
Profit	1,500
Adjustment of non-cash items Depreciation expense	 500
Changes in operating working capital items Decrease of accounts receivable -Increase in inventories Increase in accounts payable -Decrease in wages payable	 500 (1,000) 400 (600)
Cash flow from operating activities	1,300

NON-CASH TRANSACTIONS

Transactions that do not have a cash effect are not presented in the statement of cash flows (IAS7.43), unless they are a retreatment presented under the indirect method. Such transactions may include capital contributions in kind (e.g., property, plant and equipment, acquisition of assets by means of a lease, the conversion of debt to equity).

DISCLOSURES

Entities should disclose a reconciliation of the amounts in their statement of cash flows and the equivalent items reported in the statement of financial position (IAS7.45). Entities should also disclose any significant amounts of cash held by the entity that are not available for the group (IAS7.48). It may also be useful to users to find a disclosure of segmental cash flows to better understand the components of cash.

EXAMPLE SCF compilation, direct and indirect method

SCF Co. was incorporated on December 6, 2021, by a contribution in cash from its shareholders, entirely paid up, of CU3,000.

SCF then takes out a loan on December 7, for CU2,000. It repays CU250 of this loan by year end 2021. Interest has accrued on the loan for CU10 by year end, but it will be paid for later.

On December 8, SCF bought merchandise for CU700, of which it only pays CU300 in 2021.

SCF then sells half the merchandise on hand, for CU500, on account, on December 10.

SCF finally purchased a computer for cash, for CU500, on December 11. The computer is depreciated for CU50 by the end of the year. It is then sold on December 31, for CU475, in cash.

Based on these transactions, the statement of the financial position and the statement of the profit or loss are:

Statement of financial position as of 31 December 2021

Assets	**31.12.2021 (in CU)**
Current assets	**5,275**
Inventories	350
Accounts receivable	500
Cash and cash equivalents	4,425
Total assets	**5,275**
Equity and liabilities	
Share capital	3,000
Profit	115
Total equity	**3,115**
Non-current liabilities	**1,750**
Bank loans	1,750
Current liabilities	**410**
Accounts payable	400
Interest payable	10
Total liabilities	**2,160**
Total equity and liabilities	**5,275**

Statement of profit or loss for the year ended 31 December 2021

Sales	500
Cost of merchandise sold/merchandise expense	(350)
Depreciation expense	(50)
Gain on the sale of non-current assets	25
Interest expense	(10)
Profit	115

Required: prepare SCF's statement of cash flows using the direct and the indirect method, knowing that interest paid is classified as an operating cash flow.

Cash flows from operating activities (**direct method**)	
Cash payments made to suppliers of merchandise	(300)
= Net cash flow from operating activities (I)	=(300)
Cash flows from investing activities	
Cash payments to non-current asset suppliers	(500)
Cash receipts from selling non-current assets	475
= Net cash flow from investing activities (II)	=(25)
Cash flows from financing activities	
Cash receipts from capital contribution	3,000
Cash receipts from loans raised	2,000
Cash reimbursements of loans	(250)
= Net cash flow from financing activities (III)	=4,750
Total net cash flow (IV) = (I) + (II) + (III)	4,425

Cash and cash equivalents as of 06.12.2021 (V)	0
Cash and cash equivalents as of 31.12.2021 (VI) = (IV) + (V)	4,425

According to the indirect method, the cash flow from operating activities will be presented as follows:

Cash flows from operating activities (**indirect method**)	
Profit	115
1) adjustment for non-cash income or expense items	
Depreciation expense	50
2) adjustment for income or expense resulting in investing or financing cash flows	
Gain on the sale of non-current assets	(25)
3) changes in inventories, receivables, payables and other operating items	
Increase in merchandise	(350)
Increase in accounts receivable	(500)
Increase in accounts payable	400
Increase in interest payable	10
= Net cash flows from operating activities (I)	=(300)

The cash flows from investing and financing activities remain the same.