LESSON 7

Cash Flow Statement

Outline

7.1. Introduction: definition and purpose.
7.3. Definition of cash and cash equivalents.
7.4. Cash flows from operating activities.
7.5. Cash flows from investing activities.
7.6. Cash flows from financing activities
The annual accounts

- Balance Sheet
- Income Statement
- Statement of Changes in Equity
- Cash Flow Statement
- Notes to the Financial Statements

Statements of financial flows

Includes information about:
- Financial resources (cash flows) obtained by the firm during the period
- Applications of those financial resources (cash flows)
Cash Flow Statement

The Cash Flow Statement shows:

- cash receipts, and
- cash payments during the year.

These cash receipts and payments explain the changes in the cash account (*) of the Balance Sheet during the year.

(*) Cash will include cash and cash equivalents

Cash Flow Statement

Regulation

INTERNATIONAL: IAS 7

SPANISH: P.G.C. 2007

Is voluntary for:

- Companies that can publish abbreviated annual accounts
- SMEs that can apply the “PGC de PYMES 2007”
Usefulness Of Cash Flow Statement

According to IAS 7, the Cash Flow Statement should help investors and creditors assess:

- The ability to generate future positive cash flows
- The ability to meet obligations and pay dividends
- Reasons for differences between income and cash receipts and payments
- Both cash and noncash aspects of firms’ investing and financial transactions

The financial viability and survival prospects of any company rest on the ability to generate net positive cash flows.

Cash flows help to reduce an organization’s dependency on external funding, service existing debts and obligations, finance investments, and reward the investors with an acceptable dividend policy.

The end-result is that independent of reported profits, if a company is unable to generate sufficient cash, it will eventually fail.

Elliot & Elliot (2005, 613)
Cash Flow Statement

- PGC, 2007, section 3 (Annual Accounts):

  “The CFS informs about:
  - Sources and applications of cash and cash equivalents
  - classifying the movements by type of activity
  - and showing the net change in that magnitude during the exercise”.

Cash Flow Statement

Basic Concepts (PGC, 2007)

**Cash & Cash equivalents**

Those shown in heading B.VII of Assets in the Balance Sheet, that is:
- **Cash on hand**
- **Demand deposits** with financial institutions
- **Financial instruments** that are:
  1. convertible to known amounts of cash,
  2. with an original maturity of three months or less at the moment of acquisition
  3. so that they present negligible risk of changes in value
  4. and they are use in the normal cash management of the company
- **Chance bank overdrafts**, when they are used in the cash management of the company
### Cash Flow Statement
**Basic Concepts (PGC, 2007)**

#### CF from Operating Activities
Those generated from the activities that constitute the main source of revenues of the company, as well as from other transactions not classified as financing or investment activities.

The change in cash flows derived from these activities will be shown by its net value, except for the cash flows from interests, dividends received and income tax, that will be shown separately.

#### CF from Investing Activities
From the acquisition and disposal of long-term assets and other investments not included in cash equivalents, such as intangible assets, tangible assets, investment property and financial investments.

#### CF from Financing Activities
Cash receipts from the acquisition by third parties of the company’s equity or debt instruments, or from resources received from financial institutions, as well as the cash payments made for the amortization or refund of those amounts.

It also includes the cash payments to shareholders as dividends.
### Cash flows from operations

- Expenses paid in cash
- Revenues earned in cash
- Expenses paid in the short term
- Revenues earned in the short term
- Expenses paid in the long term
- Revenues earned in the long term
- Expenses that will never be paid
- Revenues that will never be earned

**Cash Flows from Operations (CFO)**

**Net Income**

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Adapted from Harrison & Horngren (2001, 540)
Cash flows from operations

Expenses paid in cash
Revenues earned in cash

Cash Flows from Operations (CFO)

There are two possible methods for calculating CFO:

- **Indirect method**
- **Direct method**

### CFO Direct method - Example

#### Cash Flows from Operating Activities (Direct method)

<table>
<thead>
<tr>
<th>Business activities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash receipts from the sale of goods and the rendering of services</td>
<td>+</td>
</tr>
<tr>
<td>Cash receipts from royalties, fees, commissions and other revenue</td>
<td>+</td>
</tr>
<tr>
<td>Cash payments to suppliers of goods and services</td>
<td>-</td>
</tr>
<tr>
<td>Cash payments to and on behalf of employees</td>
<td>-</td>
</tr>
<tr>
<td>Cash payments of V.A.T.</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial expenses and revenues:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash receipts from interest and dividends received</td>
<td>+</td>
</tr>
<tr>
<td>Cash payments of interest</td>
<td>-</td>
</tr>
</tbody>
</table>

**Income tax:**
- Cash payments or refunds of income taxes

**Cash Flows from Operations**
(Net cash from operating activities) **CFFO**
CFO Indirect method - Example

**INCOME FOR THE YEAR**

\[ \text{+/- ADJUSTMENTS TO INCOME} \]

\[ + \text{ depreciation expense} \]
\[ + \text{ losses from impairment} \]
\[ - \text{ transfers of capital grants} \]

\[ \text{...} \]

\[ \text{+/- CHANGES IN WORKING CAPITAL} \]

\[ +/\text{ change in inventory} \]
\[ +/- \text{ change in account receivables and other receivables} \]
\[ +/- \text{ change in accounts payables and other payables} \]

\[ \text{...} \]

**Cash Flows from Operations**

(Net cash from operating activities)
# Cash flows from operations

## 2. Adjustments to income

<table>
<thead>
<tr>
<th>REASONS</th>
<th>ITEMS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value corrections that do not imply a cash movement</td>
<td>a) Depreciation of fixed assets (+).</td>
</tr>
<tr>
<td></td>
<td>b) Value corrections for impairment(^1) (+/-).</td>
</tr>
<tr>
<td></td>
<td>c) Change in provisions(^2) (+/-).</td>
</tr>
<tr>
<td></td>
<td>d) Transfer of grants (-).</td>
</tr>
<tr>
<td>Income from operations that are classified as investing activities</td>
<td>e) Income from disposal of non-current assets (+/-).</td>
</tr>
<tr>
<td></td>
<td>f) Income from disposal of financial instruments (+/-).</td>
</tr>
<tr>
<td></td>
<td>g) Financial revenues (-).</td>
</tr>
<tr>
<td></td>
<td>h) Financial expenses (+).</td>
</tr>
<tr>
<td></td>
<td>i) Exchange differences (+/-).</td>
</tr>
<tr>
<td></td>
<td>j) Change in fair value of financial instruments (+/-).</td>
</tr>
<tr>
<td></td>
<td>k) Other revenues and expenses (-/+)</td>
</tr>
</tbody>
</table>

\(^1\) Impairment of non-current assets  
\(^2\) Change in long-term provisions

## 3. Changes in working capital

<table>
<thead>
<tr>
<th>(\Delta)</th>
<th>(\nabla)</th>
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</thead>
<tbody>
<tr>
<td>Revenues of this year that will generate cash receipts in future years</td>
<td>Revenues of previous years collected in cash during this year</td>
</tr>
<tr>
<td>Cash payments of this year that will be registered as expenses in future</td>
<td>Expenses of this year paid in cash in previous years</td>
</tr>
<tr>
<td>year</td>
<td></td>
</tr>
<tr>
<td>Accounts receivables and other receivables (+/-).</td>
<td>(-)</td>
</tr>
<tr>
<td>Other current assets (+/-).</td>
<td>(+)</td>
</tr>
<tr>
<td>Expenses of this year that will generate cash payments in future years</td>
<td>Expenses of previous years paid in cash during this year</td>
</tr>
<tr>
<td>Cash receipts of this year that will be registered as revenues in future</td>
<td>(-)</td>
</tr>
<tr>
<td>year</td>
<td>Revenues of this year collected in cash in previous years</td>
</tr>
<tr>
<td>Other current liabilities(+/-).</td>
<td></td>
</tr>
<tr>
<td>Other non-current assets and liabilities (+/-).</td>
<td>For specific adjustments (e.g. payment of long-term provision)</td>
</tr>
</tbody>
</table>

## Cash flows from operations

### 4. Other cash flows from operating activities

<table>
<thead>
<tr>
<th>Cash flows from operating activities</th>
<th>Direct method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Cash payments of interests (-)</td>
<td></td>
</tr>
<tr>
<td>b) Cash receipts of dividends (+)</td>
<td></td>
</tr>
<tr>
<td>c) Cash receipts of interests (+)</td>
<td></td>
</tr>
<tr>
<td>d) Cash receipts (payments) for income taxes (+/-)</td>
<td></td>
</tr>
<tr>
<td>e) Other cash payments (receipts) (-/+)</td>
<td></td>
</tr>
</tbody>
</table>

## Cash flows from investment activities

<table>
<thead>
<tr>
<th>Cash flows from investment activities</th>
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</thead>
<tbody>
<tr>
<td>b) CASH FLOWS FROM INVESTMENT ACTIVITIES</td>
<td></td>
</tr>
<tr>
<td>6. Cash payments for investments (-)</td>
<td></td>
</tr>
<tr>
<td>a) Subsidiaries and associated companies.</td>
<td></td>
</tr>
<tr>
<td>b) Intangible assets.</td>
<td></td>
</tr>
<tr>
<td>c) Tangible fixed assets.</td>
<td></td>
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<tr>
<td>d) Investment property.</td>
<td></td>
</tr>
<tr>
<td>e) Other financial assets.</td>
<td></td>
</tr>
<tr>
<td>f) Non-current assets held for sale.</td>
<td></td>
</tr>
<tr>
<td>g) Other assets.</td>
<td></td>
</tr>
<tr>
<td>7. Cash receipts from disinvestments (+)</td>
<td></td>
</tr>
<tr>
<td>a) Subsidiaries and associated companies.</td>
<td></td>
</tr>
<tr>
<td>b) Intangible assets.</td>
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<tr>
<td>c) Tangible fixed assets.</td>
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<td>d) Investment property.</td>
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<td>e) Other financial assets.</td>
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<td>f) Non-current assets held for sale.</td>
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<tr>
<td>g) Other assets.</td>
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</tr>
</tbody>
</table>
## Cash flows from financing activities

### C) CASH FLOWS FROM FINANCING ACTIVITIES

#### 9. Cash receipts and payments for equity instruments

- a) Issuing of equity instruments (+)
- b) Amortization of equity instruments (-)
- c) Acquisition of the own equity instruments (-)
- d) Disposal of the own equity instruments (+)
- e) Grants, donations and legacies received (+)

#### 10. Cash receipts and payments for debt instruments

- a) Issuing of
  1. Debentures and other negotiable securities (+)
  2. Long term debt payable to credit institutions (+)
  3. Long term debt payable to subsidiaries and associated companies (+)
  4. Other debt (+)
- b) Refunds and amortization of
  1. Debentures and other negotiable securities (-)
  2. Long term debt payable to credit institutions (-)
  3. Long term debt payable to subsidiaries and associated companies (-)
  4. Other debt (-)

#### 11. Cash payments of dividends and remuneration of other equity instruments

- a) Dividends (-)
- b) Remuneration of other equity instruments (-)

#### 12. Cash receipts and payments for debt instruments

- a) Refunds and amortization of
  1. Debentures and other negotiable securities (+)
  2. Long term debt payable to credit institutions (+)
  3. Long term debt payable to subsidiaries and associated companies (+)
  4. Other debt (+)
- b) Issuing of
  1. Debentures and other negotiable securities (-)
  2. Long term debt payable to credit institutions (-)
  3. Long term debt payable to subsidiaries and associated companies (-)
  4. Other debt (-)