Chapter 7

Cash flow statements

Slow payers and cash flow problems . . .

Crunch highlights cash flow

Judith Tydd

Economic instability is forcing a growing number of corporations to look at the way in which cash flow management is applied.

Bill Dodwell, tax partner at Deloitte, said the consensus among businesses prior to the collapse of global markets was to relegate cash flow management behind more compliance related areas.

'People haven't previously focused on it nearly as much as what they are now,' he said.

VAT systems are of particular significance to companies as this has a direct impact on cash flow from sales produced and, according to Dodwell, resulting VAT numbers have the potential to be 'huge'.

'Companies haven't bothered to look at whether their system is proper. It's about ensuring you're paying the right amount of tax at the right time,' he said.

Richard Mannion, national tax director at Smith & Williamson, said any well-run businesses should be aware of its cash flow management system. 'It's critical for people to be doing cash flow very carefully. It has come as a shock for business plans put in place last year which hadn't factored in the downturn in the market,' he said.

Source: *Accountancy Age*, 9 October 2008.

Source: Reproduced with permission from Incisive Media Ltd.

Questions relating to this news story can be found on page 163

About this chapter

This chapter deals with *cash flow statements* (CFS). A CFS is a financial statement listing all the cash receipts and all the cash payments for a certain period of time. It is now considered to be one of the main financial statements along with the profit and loss account and the balance sheet. Its importance was clearly recognized in 1991 when cash flow became the very first *Financial Reporting Standard* (FRS 1). The subject is also covered by an IASB requirement (IAS 7).

Learning objectives

By the end of this chapter you should be able to:

- explain what is meant by a cash flow statement;
- describe its purpose;
- prepare a simple cash flow statement;
- outline the main structure of a cash flow statement in accordance with FRS 1 and IAS 7;
- identify the main causes of a change in cash flow during an accounting period.

Why this chapter is important

This chapter is exceptionally important for non-accountants, especially those who are hoping to become senior managers in any entity no matter what its type or size. No entity can survive unless it takes in more cash than it is paying out and that applies both in the short term and in the long term. So all managers have to make sure that there is enough cash available (or they can borrow enough) to meet their debts. If they cannot then their business will go bankrupt.

It follows that managers must monitor their cash position constantly. One way of doing this is for their accountants to give them a cash flow statement on a frequent and regular basis.

As a manager, a CFS will not mean much to you if you do not know where the information has come from, what it means and what you should do with it. This chapter gives you the knowledge to make full use of all that it will tell you.

Nature and purpose

News clip

More about the Olympics

The British Olympic Association has had to have a £2m advance as it faced a cash crisis resulting from £1m spent on consultants and pay-offs for ex-staff. The move was necessary to give it time to renegotiate its overdraft. The BOA made a £1.5m pre-tax loss in 2008.

Source: Adapted from *The Guardian*, 18 June 2009, p. 10.

A cash flow statement (CFS) is a summary of all the cash that an entity has received for a period of account and all the cash payments that it has made during the same period. The net balance is then usually added (or deducted) to the opening balance to arrive at the closing balance. An example of a simple CFS is shown in Figure 7.1.

A CFS is now considered to be one of the main financial statements along with the profit and loss account and the balance sheet. It has become so because it provides vital information about an entity's cash position that is not disclosed in either the profit and loss account or the balance sheet, i.e. how it got to its current cash position.

Belton Limited
Cash flow statement for the year to 31 March 2012

	2011 £000	2012 £000
Receipts		
Trade debtors	1,410	**1,990**
Debenture interest	–	**400**
	1,410	**2,390**
Payments		
Trade creditors	720	**1,400**
Expenses	430	**560**
Development costs	20	**250**
Fixed assets	95	**455**
Debenture stock	100	–
Tax paid	20	**70**
Dividends paid	30	**60**
	1,415	**2,795**
Net payments	(5)	**(405)**
Opening cash	10	**5**
Closing cash	5	**(400)**

Figure 7.1 Example of a cash flow statement

After working your way through this book so far, you might find this argument somewhat contradictory. You would have a point. In previous chapters we have emphasized just how important it is to show where the entity's *profit* has come from and now we are arguing for *cash*.

The truth is that both cash and profit are important: cash because an entity will not last overnight if it has not got the money to pay what it owes and profit because it will not survive in the long-run if it does not make a profit.

So, in summary: remember that (1) cash received less cash paid is not the same as profit; (2) an entity needs enough cash to keep going; and (3) it has to make a profit in the long-run. So users of accounts need information about an entity's cash position **and** its profitability.

In the next section we explain how to prepare a CFS so that when you come across one you will know where the information has come from, what it means and what you should do about it.

Activity 7.1

Go through Figure 7.1 identifying the main item that explains why a favourable cash balance of £5000 has turned into an unfavourable one of £400,000.

Preparation

There are two recognized ways of preparing a CFS: the *direct method* and the *indirect method*. The direct method is basically a summary of all the entries made in the cash book. In theory it is an easy and simple way of preparing a CFS. In practice it can involve a lot of extra work because all the accounting entries need to be converted back on to a cash basis. So most entities opt for the indirect method. This method simply extracts and adapts where necessary the data included in the profit and loss account and the balance sheet. As a result this method shows a clear link and a close relationship between the CFS and the financial statements, as can be seen in Figure 7.2.

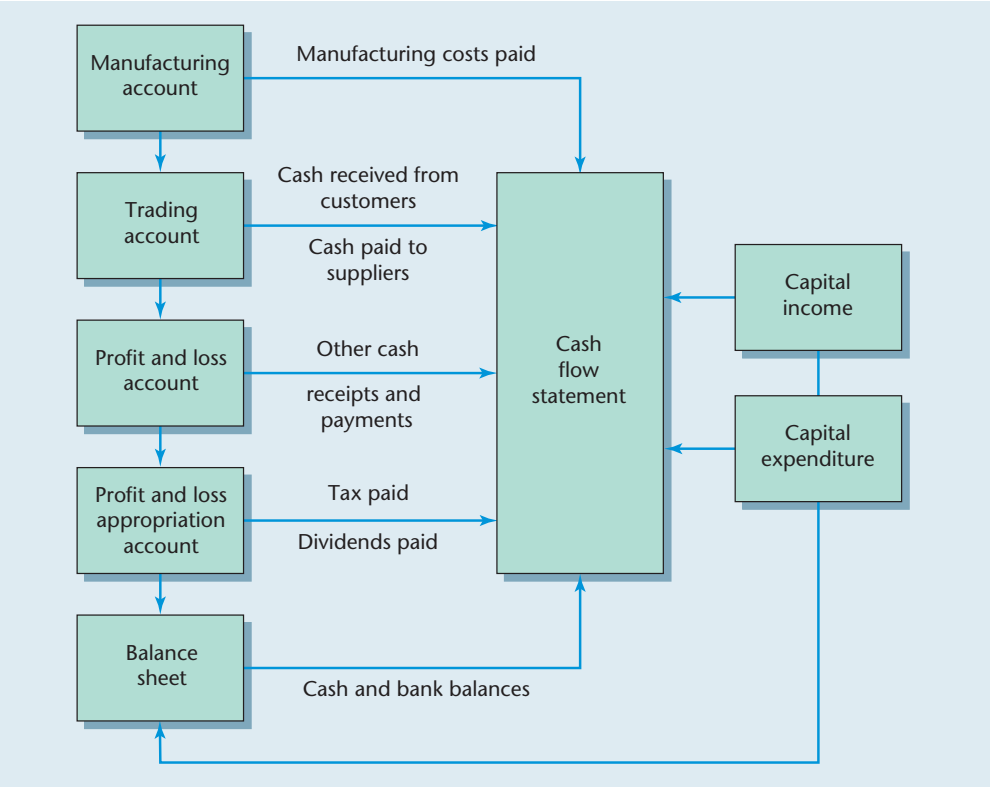

Figure 7.2 The interrelationship between the main financial statements

During your career you might well come across both the direct and the indirect methods so we will show you both methods using the same example. First the direct method.

The direct method

Example 7.1

Preparation of a cash flow statement

You are presented with the following information:

Durton Ltd
Cash book summary for the year to 31 December 2012

Receipts	*£000*	*Payments*	*£000*
Balance b/f	25	Trade creditors	680
Trade debitors	970	Operating expenses	135
10% debenture stock	100	Debenture interest	10
		Taxation	40
		Dividends	30
		Fixed assets	150
		Balance c/f	45
	1 095		1 095

Required:
Prepare Durton's cash flow statement for the year to 31 December 2012 using the direct method.

Answer to Example 7.1

Durton Ltd
Cash flow statement for the year to 31 December 2012 using the direct method

	Tutorial notes	*£000*
Cash receipts		
Sale of goods	1	970
Issue of 10% debenture stock	2	100
		1 070
Cash payments		
Purchases of goods	3	680
Operating expenses		135
Debenture interest paid	4	10
Tax paid	5	40
Dividends paid	6	30
Fixed assets purchased	7	150
		1 045
Increase in cash during the year	8	25
Cash at 1 January 2012		20
Cash at 31 December 2012		45

Tutorial notes

1 This amount has been received in cash from trade debtors during the year.

2 The cash received from the sale of the debenture stock will not be shown in the profit and loss account.

3 This amount is what has been paid to trade creditors during the year.

4 The debenture stock has apparently been issued on 1 January 2012 because £10 000 is the total amount of interest for a full year.

5 An amount paid during the year but we do not know to which year or years it relates.

6 The dividends may or may not be related to 2012 or they could be a final dividend declared in 2011 and paid in 2012.

7 The cost of fixed assets, of course, would not be included in the profit and loss account.

8 The increase in cash during the year is probably a mixture of cash received and paid during 2012 some of which relates to 2011 and some to 2013.

As you worked your way through Example 7.1 you probably found it fairly easy because you were given a highly summarized version of the cash book and this provided most of the information you needed. It would have been a little more difficult to prepare if you had had to extract what you wanted from a poorly kept handwritten cash book (still found these days even with the benefits of computerization). But even if the CFS is fairly easy to prepare the information provided appears to be independent of the other two main financial statements: the profit and loss account and the balance sheet. This means that they tend to be viewed in isolation. It can also be confusing for those users of financial statements who are not clear about the difference between 'cash' and 'profit'. The indirect method gets over these problems even if it is perhaps a little more difficult to understand. So now to the indirect method.

Activity 7.2

Make a list of those items that appear in Durton's CFS that would not normally be included in its profit and loss account.

The indirect method

News clip

GM cash drain

General Motors, the American car firm faces a survival crisis owing to an unexpected heavy cash drain during the last three months of 2008. So much so that it thinks its auditors may not regard it as a going concern.

Source: Adapted from *The Financial Times*, 27 February 2009.

We illustrate how the indirect method works in Example 7.2. As with Example 7.1 it relates to Durton Limited but this time we need to give you the company's profit and loss account for 2012 and the balance sheets for both 2011 and 2012.

Example 7.2

Preparation of a cash flow statement using the indirect method

You are presented with the following information:

Durton Ltd
Trading and profit and loss account for the year to 31 December 2012

	£000	*£000*
Sales		1 000
Less: Cost of goods sold:		
Opening stock	200	
Purchases	700	
	900	
Less: Closing stock	300	600
Gross profit		400
Operating expenses		(240)
Operating profit		160
Debenture interest		(10)
Net profit before taxation		150
Taxation		(50)
Net profit after taxation		100
Dividends		(60)
Retained profit for the year		40

Durton Ltd
Balance sheet at 31 December 2012

	2011		2012	
	£000	£000	£000	£000
Fixed assets at cost	900		1 050	
Less: Accumulated depreciation	150	750	255	795
Current assets				
Stocks	200		300	
Trade debtors	120		150	
Cash	20		45	
	340		495	
Less: *Current liabilities*				
Trade creditors	70		90	
Taxation	40		50	
Proposed dividend	30		60	
	140	200	200	295
		950		1 090
Capital and reserves				
Ordinary shares of £1 each		750		750
Profit and loss account		200		240
		950		990
Loans				
Debenture stock (10%: issued 1 January 2012)		–		100
		950		1 090

Required:
Prepare a cash flow statement for the year to 31 December 2012 using the indirect method.

Answer to Example 7.2

Durton Ltd
Cash flow statement for the year to 31 December 2012

	Tutorial notes	£000
Cash receipts		
Sale of goods	1	970
Issue of debenture stock	2	100
		1 070
Cash payments		
Purchases of goods	3	680
Operating expenses	4	135
Debenture interest paid	5	10
Taxation	6	40
Dividends	7	30
Purchases of fixed assets	8	150
		1 045
Increase in cash during the year 2012		25
Cash at 1 January 2012		20
Cash at 31 December 2012		45

Answer to Example 7.2 continued

1 Sale of goods = (opening debtors + sales) – closing debtors: (1 000 + 120) – 150 = 970.
2 Issue of debenture stock: 100 – 0 = 100.
3 Purchases of goods: 700 + 70 – 90 = 680.
4 Operating expenses – depreciation: 240 – 105* = 135 [*accumulated depreciation balances: 255 – 150].
5 Debenture interest: 10% × 100 = 10.
6 Taxation: 40. Only last year's has been paid as the taxation in the profit and loss account is the same amount shown in the balance sheet.
7 Dividends: 30. Only last year's has been paid as the dividends in the profit and loss account is the same balance as shown in the balance sheet.
8 Purchase of fixed assets: 1 050 – 900 = 150.

We can now begin to work out what Durton's CFS is telling us. The balance sheet shows that at 31 December 2011 the company had a cash balance of £20,000. By 31 December 2012, the cash balance was £45,000, an increase of £25,000. The retained profit for the year of £40,000 was more than the £25,000 increase in cash during the year. We do not, of course, need to prepare a CFS to find out such information but we do need some help in determining why there is a difference. A CFS provides us with the evidence. Most of the cash received for the year came from sales and much of it was spent on buying goods, but if you look at the CFS a little more closely, however, you will also see that £100,000 was raised by issuing some debenture stock and that £150,000 was incurred on purchasing some fixed assets. These items do not appear in the profit and loss account. There is probably a connection between them: the debentures might have been issued to finance the purchase of the fixed assets. Certainly, without the debentures the cash position at the end of the year would have been very different, e.g. an overdrawn amount of £55,000 (45,000 – 100,000) instead of a favourable balance of £45,000. Similarly, if the taxation balance of £50,000 and the proposed dividend of £60,000 at 31 December 2012 had had to be paid early in 2013, the cash position would have been extremely vulnerable. Durton Ltd would then have to depend on its trade debtors (£150,000 at 31 December 2012) settling their debts before it could pay its trade creditors of £90,000.

Durton's CFS is a simplified example of a company's cash flow statement. Nevertheless, it does enable the major cash items to be highlighted and to bring them to the attention of the managers and to the owners of the company. Although it is to be hoped that the cash position of Durton was being closely monitored during the year, an annual CFS enables the year's results to be put into context.

Activity 7.3

Durton Limited retained profits of £40,000 for the year to 31 December 2012 and yet its cash balance only increased from £20,000 at the beginning of the year to £45,000 at the end of it. The managing director (a salesperson) thinks that someone has defrauded the company of £15,000. Let him have a note (via email) explaining to him why this is not so.

The layout that we have used in preparing the solution to Example 7.2 does not demonstrate very clearly the close relationship between the profit and loss account, the balance sheet and the CFS. The various changes that have been made are also somewhat difficult to trace. If it is possible, a CFS should be presented in such a way that its close relationship with the profit and loss account and the balance sheet is much more apparent.

Both the ASB and the ISAB have issued an accounting standard covering CFSs: FRS 1 and IAS 7 respectively. They are not identical: slightly different accounting policies are used to prepare them, some terminology is different and the formats (e.g. the headings) are not the same. Overseas students (especially those from EU countries) are likely to use the IASB's version. However, UK students will probably come across both FRS 1 and IAS 7 so we will deal with each of them. First FRS 1.

FRS 1 presentation

FRS 1 was first issued in 1991 and revised in 1996. It is quite a complicated standard but we will make matters easier for you by dealing only with a CFS for single entities. We are only going to cover the indirect method as this is the method that you are much more likely to come across. Our discussion will be in two parts: (1) an example of a CFS as required by FRS 1; and (2) an explanation of some of its main features.

We will use Durton Limited's accounts as our example because by now you should be familiar with the details.

Example 7.3

Preparation of a cash flow statement in accordance with FRS 1 using the individual method

Using the data from Durton Limited, Example 7.2 on pages 150–151, prepare a cash flow statement in accordance with FRS 1 using the indirect method.

Durton Ltd
Cash flow statement for the year to 31 December 2012

	Tutorial notes	*£000*
Net cash inflow from operating activities	1	155
Returns on investments and servicing of finance		
Interest paid	7	(10)
Taxation	8	(40)
Capital expenditure		
Payments to acquire tangible fixed assets	9	(150)
Equity dividends paid	10	(30)
		(75)
Management of liquid resources and financing		
Issue of debenture stock	11	100
Increase in cash	12	25

Note 1 Reconciliation of operating profit to net cash inflow from operating activities

	Tutorial notes	*£000*
Operating profit	2	160
Depreciation	3	105
(Increase) in stocks	4	(100)
(Increase) in trade debtors	5	(30)
Increase in trade creditors	6	20
Net cash inflow from operating activities	1	155

Example 7.3 continued

Note 2 Reconciliation of net cash flow to movement in debt

	Tutorial notes	*£000*
Increase in cash during the period	12	25
Cash from issuing debentures	13	(100)
Change in net debt	14	(75)
Net funds at 1 January 2012	15	20
Net debt at 31 December 2012	16	55

Note 3 Analysis of change in net debt

	At 1.1.12	**Cash flows**	**At 31.12.12**
	£000	*£000*	*£000*
Cash	20 (15)	25 (12)	45 (17)
Debt due after one year	– (15)	(100) (13)	(100) (13)
Total	20 (15)	(75) (14)	(55) (16)

Tutorial notes to Example 7.3

1 The calculation of the net cash inflow from operating activities totalling £155,000 is shown in **Note 1** to the CFS. This note is required although it is not a formal part of the CFS 1.

2 The operating profit of £160,000 has been obtained from the profit and loss account.

3 The depreciation charge has been obtained from the balance sheet. It is the difference between the accumulated depreciation of £255,000 as at 31 December 2012 and £150,000 as at 31 December 2011.

4 The increase in stocks has been obtained from the two balance sheets. It is the movement between the two balances of £300,000 and £200,000. Note that an increase in stocks is the equivalent of a *reduction* in cash because more cash will have been paid out.

5 The increase in trade debtors of £30,000 represents the movement between the opening and closing trade debtors as obtained from the two balance sheets. An increase in trade debtors represents a *reduction* in cash because less cash has been received by the entity.

6 The increase in trade creditors of £20,000 is again obtained from the balance sheets. The £20,000 represents an *increase* in cash because less cash has been paid out of the business.

7 The interest paid of £10,000 has been obtained from the profit and loss account.

8 The taxation amount of £40,000 is the balance shown on the previous year's balance sheet. As £50,000 was charged to this year's profit and loss account for taxation and this amount features on this year's balance sheet, only £40 000 must have been paid during the year.

9 The capital expenditure amount of £150,000 is the difference between the two balance sheet amounts for fixed assets, of £1,050,000 and £900,000 respectively. No further details are given.

10 The equity dividends of £30,000 represent the dividends paid out to ordinary shareholders during the year (there are no other groups of shareholders in this example). The amount has been obtained from the 2011 balance sheet.

The 2012 balance sheet shows an amount of £60,000, which is the same amount as disclosed in the profit and loss account. This means that only last year's dividend has been paid during the current year. Sometimes, there would also be other payments during the year.

11 The debenture stock balance has been obtained from the 2012 balance sheet. There was no such balance at the end of 2011, and so all the debenture must have been issued during 2012, as indeed is stated in the example.

12 After making all the above adjustments to the financial accounts, the net increase in cash during 2012 is found to be £25,000.

13 See note 11 above.

14 Without the issue of the debentures, there would have been a £75,000 net outflow of cash during the year.

15 The company only had cash at 1 January 2012; it did not have any debt.

16 The entity's net debt at 31 December 2012 was £55,000, i.e. the debenture stock of £100,000 less the cash in hand of £45,000.

17 This was the cash balance at 31 December 2012, as shown in the balance sheet at that date.

Main features

We hope that you have been able to work your way carefully through Example 7.3 line by line and note by note without too much difficulty. We think that you will agree that it is not particularly easy to follow even if you are familiar with the data. We will now try to pull out some of the main features and difficulties in order to enable you to compile simple CFSs for yourself. If you can do that then you should be able to cope with more complex presentations that you may come across in your job.

Layout

FRS 1 requires eight main headings, as summarized in Table 7.1 below. Example 7.3 only uses six headings because in this example there are no data for one heading (acquisitions and disposals) and two headings may be combined (management of liquid resources and financing) as long as they are shown separately elsewhere.

Cash

You might think that there is no need to define what is meant by 'cash'. After all, everyone knows it is just notes and coins that you have in your pocket, tucked under the mattress or perhaps kept at the bank. FRS 1's definition is a little wider than this. It is as follows:

Cash = cash in hand + deposits – overdrafts

The definition of cash is not a problem: coins and bank notes and cash at the bank that give you instant access. Similarly you almost certainly know all about overdrafts! The definition of deposits is, however, a little trickier. According to FRS 1 deposits are regarded as the same as 'cash' when they are with a 'qualifying institution' (i.e. an entity that accepts deposits or other repayable funds and grants credits for its own account) and that are repayable on demand within at least 24 hours. Both cash and deposits may be in foreign currencies.

Table 7.1 Structure of a cash flow statement according to FRS 1

Heading[a]	Contents[b]
1 Net cash inflow from operating activities	Operating or trading activities[c]
2 Returns on investments and servicing of finance	Investment income. Interest payments on loans. Dividends paid to preference shareholders
3 Taxation	Tax paid on profits
4 Capital expenditure and financial investment[d]	Purchases and sales of fixed assets. Loans to other entities received and paid
5 Acquisitions and disposals	Sales and purchases of other entities or of investments in them
6 Equity dividends paid	Dividends paid to ordinary shareholders
7 Management of liquid resources[e]	Purchases and sales of current asset investments
8 Financing[e]	Receipts and payments relating to share issues and redemptions, debentures, loans and other long-term borrowings

Notes:
(a) Headings may be omitted if no cash transaction has taken place either in the current period or in the previous period. They must be in the order listed. A subtotal should be included for each heading.
(b) The contents reflect only the *cash* flow for each transaction. Cash includes cash in hand, deposits repayable on demand, and overdrafts. *Cash flow* is an increase or decrease in cash during the period.
(c) FRS 1 requires a reconciliation to be made between the operating profit and the net cash flows from operating activities.
(d) The heading 'capital expenditure' may be used if there are no cash flows relating to financial investment (such as loans).
(e) Headings 7 and 8 may be combined under one heading provided that each of their respective cash flows are shown separately and that separate subtotals are given for each heading.

This definition of cash is important because, as you will see later, IAS 7's definition is not the same.

Notes

FRS 1 requires three main significant notes to accompany the CFS: one reconciling the operating profit to operating cash flow; one reconciling net cash flow to the movement in debt; and one analysing the change in net debt. These are all tricky notes to compile and they require some thought. So be warned!

1 Note reconciling operating profit to operating cash flows

This reconciliation basically converts the traditional profit and loss account items prepared on an accruals and payments basis back to a cash basis. We do this by adding to or deducting any increase or decrease in opening and closing debtors, prepayments, creditors and accruals. So, for example, if closing trade debtors are greater than the opening trade debtors we *deduct* the increase from the operating profit. We do this because, other things being equal (*ceteris paribus*), less cash has been received during the year. If the closing trade debtors are less than opening ones we *add* the decrease to the operating profit. Again we do this because, *ceteris paribus*, more cash has been received during the year.

This notion of adding or deducting the movement between the opening and closing current asset and current liability balances is sometimes quite difficult to grasp and so to work out. In order to make it much easier for you we have summarized the procedure in Table 7.2 below.

Table 7.2 The effect of working capital movements on cash flow

Item	Movement (closing balance less opening balance)	Effect on cash
Stocks	Increase	Down (more cash has been spent on stocks). Insert the movement in brackets
	Decrease	Up (less cash has been spent on stocks)
Trade debtors, other debtors and prepayments	Increase	Down (less cash has been received). Insert the movement in brackets
	Decrease	Up (more cash has been received)
Trade creditors, other creditors and accruals (excluding taxation payable and proposed dividends)	Increase	Up (less cash has been spent)
	Decrease	Down (more cash has been paid). Insert the movement in brackets

Activity 7.4

State whether each of the following statements is true or false.

(a) Operating activities reflect total cash inflows. *True/false*
(b) Depreciation decreases the cash position. *True/false*
(c) Tax paid decreases the tax position. *True/false*
(d) A proposed dividend increases the cash position. *True/false*
(e) A decrease in debtors increases the cash position. *True/false*
(f) An increase in creditors decreases the cash position. *True/false*

2 Note reconciling net cash flow to movement in net debt

The second note required by FRS 1 involves preparing a schedule reconciling the difference between the net debt at the beginning of the period and net debt at the end of it. Net debt is basically the difference between long-term loans and any cash and bank balances (net *funds* if the cash and bank balances are greater than the net debt). This note helps users of financial statements to assess the liquidity position of the company and to determine its solvency.

Such a note is usually quite a simple one to prepare. It has three main elements:

- the change in the cash for the period;
- the movement in debt during the period;
- the net debt at the end of the period.

The note is usually shown immediately after the CFS itself.

3 Note analysing changes in net debt

The third note involves analysing the changes that have taken place in the net debt position during the period. Net debt is split between cash and debt. These two elements are then analysed into:

- the balances at the beginning of the period;
- changes that happened during the period;
- the balances at the end of the period.

This note usually follows Note 2.

We now leave FRS 1 and in the next section we explain how to prepare and present a CFS in accordance with IAS 7.

IAS 7 FORMAT

News clip

BA Cuts

In order to save cash and reduce losses British Airways is reducing capacity and cutting jobs. This move involves reducing capital expenditure and deferring deliveries of new aircraft.

Source: Adapted from *The Financial Times*, 4/5 July 2009, p. 12.

In this section we examine a CFS prepared according to IAS 7. We will follow a similar procedure to the one we adopted in the last section, i.e. a CFS example and an outline of its main features. And again we are going to limit our discussion to the indirect method.

Example 7.4

Preparation of a cash flow statement in accordance with IAS 7 using the individual method

Using the data from Durton Limited, Example 7.2 on pages 150–151, prepare a cash flow statement in accordance with IAS 7 using the indirect method.

Durton Ltd
Statement of cash flows as at 31 December 2012

	Tutorial notes	*2012*	
		£000	*£000*
Cash flows from operating activities			
Profit before taxation	1	160	
Adjustments for:			
Depreciation	2	105	
		265	
Increase in trade and other receivables	3	(30)	
Increase in inventories	4	(100)	
Increase in trade payables	5	20	
Cash generated from operation		155	
Interest paid	6	(10)	
Income tax paid	7	(40)	
Net cash from operating activities			105
Cash flows from investing activities			
Purchase of property, plant and equipment	8	(150)	
Net cash used in investing activities			(150)
	c/f		(45)

	Tutorial notes	*2012*	
		£000	*£000*
b/f			(45)
Cash flow from financing activities			
Proceeds from long-term borrowings	9	100	
Dividends paid	10	(30)	
Net cash used in financing activities			70
Net increase in cash and cash equivalents	11		25
Cash and cash equivalents at 1 January 2012			20
Cash and cash equivalents at 31 December 2012			45

Tutorial notes to Example 7.4

1 Net profit before taxation + debenture interest: 150 + 10 = 160.
2 Depreciation: 255 – 150 = 105.
3 Increase in trade and other receivables: 150 – 120 = 30.
4 Increase in inventories: 300 – 200 = 100.
5 Increase in trade payables: 90 – 70 = 20.
6 Interest paid: 10 (10% × 100).
7 Income tax paid: 40 + 50 – 50 = 40.
8 Purchase of property, plant and equipment: 1 050 – 900 = 150.
9 Proceeds from long-term borrowings: 100 – 0 = 100.
10 Dividends paid: 30 + 60 – 60 = 30.
11 Net increase in cash and cash equivalents: 45 – 20 = 25.

Note:

We have used exactly the same data from Durton Limited to prepare a CFS under both FRS 1 and IAS 7. In practice this would not normally be possible without some amendments since the ASB and the IASB have slightly different accounting policies. The example is fictitious, however, and our purpose in this chapter is only illustrative.

Main features

Both the ASB and the IASB accept that entities should produce a CFS. There are differences, between them, such as layout, terminology and detail. These differences are, however, relatively minor.

Layout

You will see from Example 7.4 that a CFS prepared under IAS 7 only has three main headings (compared with FRS 1's eight): *operating activities, investing activities* and *financing activities.* The standard allows a great deal of discretion about what to include under each heading.

Operating activities include those incomes and expenses that you would normally find in the profit and loss account suitably adjusted for debtors, creditors, accruals and prepayments plus depreciation. The adjustments that you need to make are identical to the ones we outlined for you in the previous section (see Table 7.2). Investing activities

may include the purchases and sales of long-term assets and investments while financing activities include cash from the sale and purchase of the company's own shares, debentures and loans. In practice, when dealing with the affairs of a large company, it is not always easy to decide between investing and financing activities.

Cash and cash equivalents

IAS 7's definition of cash is a little wider than that of FRS 1 as it includes *cash equivalents*. Cash equivalents are:

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

A maturity date of up to three months is usually taken as a guide to what is meant by 'short-term, highly liquid investments'.

Notes

An IAS 7 prepared CFS does not require specific notes about the movement in net debt and an analysis of the changes in net debt.

News clip

The biggest headaches

A recent survey shows that credit and cash flow management are the biggest headaches affecting finance leaders. The survey shows that 75% of Chief Financial Officers are most concerned about credit and 51% of them about cash flow management.

Source: Adapted from *accountancymagazine*, November 2008, p. 37.

The differences between an ASB prepared CFS and one prepared under IASB requirements are not particularly significant and its precise format does not really matter. What does matter is that as a manager (a) you receive some sort of CFS; (b) that you know what it is; and (c); and you know what action to take when you receive it. It could help to save your job and your company!

Activity 7.5

Compare and contrast Durton Limited's CFSs given in this chapter (Example 7.3 and Example 7.4, pages 153–154 and 158–159) prepared under FRS requirements and the other prepared under IASB requirements. List what you like and what you dislike about each format and then come to a conclusion about which format you prefer.

Questions you should ask

It is unlikely that as a non-accountant you will have to prepare cash flow statements. Your accountants will do that for you and present you with them from time to time.

We will assume that after studying this chapter you know where the information comes from and what it means. So what questions should you ask? We suggest that the following may be appropriate.

- Why has there been an increase or a decrease in cash during the period?
- What are the main items that have caused it?
- Did we anticipate them happening?
- What caused them?
- What did we do about any likely problems?
- Are we going to be short of cash in the immediate period?
- Will the bank support an extension of our overdraft?
- Can we borrow some funds from elsewhere?
- Might we need to borrow some on a long-term basis?
- How will that affect our future cash position?
- And what impact will it have on our profitability?

Conclusion

A cash flow statement for management contains some extremely useful information because it gives a lot more detail about the movement in the cash position. This is vital as it is possible for an entity to be profitable without necessarily having the cash resources to keep it going. Strict control over cash resources is absolutely essential, and a cash flow statement can help in this respect especially one prepared using the indirect method as it links directly with the profit and loss account and the balance sheet.

Key points

1. Entities may have a long-term profitable future but in the short term they may be short of cash. This may curb their activities and in extreme cases they may be forced out of business.
2. To avoid this happening owners and managers should be supplied with information about the cash movement and resources of the entity, i.e. about its liquidity. This can be done by preparing a cash flow statement.
3. A cash flow statement can be prepared using any format. Listed companies in the EU must use IAS 7 in preparing their *group* financial statements as they are required to adopt IASB requirements. Non-listed companies in the UK may use either IAS 7 or the ASB's FRS 1. Non-listed companies in other EU countries may have a similar arrangement.

Key points continued

4 Both IAS 7 and FRS 1 permit the use of either the direct method or the indirect method. The direct method is basically a list of the receipts and payments extracted from the cash book. The indirect method takes the respective balances from the profit and loss account and the balance sheet and converts them back from an accruals and payments basis to a cash basis. This method is to be preferred because it establishes an obvious and clear link between the CFS and the other two financial statements.

Check your learning

The answers to these questions can be found within the text.

1 List five reasons why the accounting profit for a period will not necessarily result in an improvement in an entity's cash position.

2 Identify two balance sheet items that may change an entity's cash position.

3 How does depreciation affect the cash balance?

4 What two methods may be used for preparing a CFS?

5 What Financial Reporting Standard covers the preparation of CFSs?

6 How many headings does the standard suggest for a CFS?

7 What are they?

8 Does an *increase* in (a) stocks, (b) debtors, and (c) creditors increase or decrease the cash position?

9 Does a *decrease* in (a) stocks, (b) debtors, and (c) creditors increase or decrease the cash position?

10 What is (a) net debt, (b) net funds?

11 What International Accounting Standard covers the preparation of a CFS?

12 How many headings does this standard require?

13 What are they?

14 What UK entities may adopt IAS 7?

15 What type of EU entity must adopt IAS 7?

16 List the assumptions and estimates that have to be made when compiling a CFS.

17 How reliable is a CFS?

18 What action would you expect a manager to take on receiving a CFS based on (a) historical data, (b) forecasted data?

News story quiz

Remember the news story at the beginning of this question? Go back to that story and reread it before answering the following questions.

The credit crunch that began to have a major impact on the UK economy in 2007 resulted in much more attention being given to cash flow. This article is one of many reports about what companies have had to do since that time.

Questions

1 Why is VAT an important element of cash flow management?

2 Why is it particularly significant during a recession?

3 What factors may cause inefficient cash management during periods of boom?

Tutorial questions

The answers to questions marked with an asterisk can be found in Appendix 4. Questions 7.4 to 7.9 may be answered by following the requirements of either FRS 1 or IAS 7.

7.1 'Proprietors are more interested in cash than profit.' Discuss.

7.2 Unlike traditional financial accounting, cash flow accounting does not require the accountant to make a series of arbitrary assumptions, apportionments and estimates. How far, therefore, do you think that there is a case for abandoning traditional financial accounting?

7.3 Does a cash flow statement serve any useful purpose?

7.4* You are presented with the following information:

Dennis Limited
Balance sheet at 31 January 2010

		31 January 2009		*31 January 2010*	
		£000	*£000*	*£000*	*£000*
Fixed assets					
Land at cost			600		700
Current assets					
Stock		100		120	
Debtors		200		250	
Cash		6		10	
	c/f	306	600	380	700

	31 January 2009		*31 January 2010*	
	£000	*£000*	*£000*	*£000*
b/f	306	600	380	700
Less: *Current liabilities*				
Creditors	180	126	220	160
		726		860
Capital and reserves				
Ordinary share capital		700		800
Profit and loss account		26		60
		726		860

Required:
(a) Prepare Dennis Limited's cash flow statement for the year ended 31 January 2010.
(b) Outline what it tells the managers of Dennis Limited.

7.5* The following balance sheets have been prepared for Frank Limited:

Balance sheets at:	28.2.11		28.2.12	
	£000	*£000*	*£000*	*£000*
Fixed assets				
Plant and machinery at cost		300		300
Less: Depreciation		80		100
		220		200
Investments at cost		–		100
Current assets				
Stocks	160		190	
Debtors	220		110	
Bank	–		10	
	380		310	
Less: *Current liabilities*				
Creditors	200		160	
Bank overdraft	20		–	
	220	160	160	150
		380		450
Capital and reserves				
Ordinary share capital		300		300
Share premium account		50		50
Profit and loss account		30		40
		380		390
Shareholders' funds				
Loans				
Debentures		–		60
		380		450

Additional information:
There were no purchases or sales of plant and machinery during the year.

Required:
(a) Prepare Frank Limited's cash flow statement for the year ended 28 February 2012.
(b) What does it tell the managers of Frank Limited?

7.6 You are presented with the following information:

Starter
Profit and loss account for the year to 31 March 2012

	£	£
Sales		10 000
Purchases	5 000	
Less: Closing stock	1 000	4 000
Gross profit		6 000
Less: Depreciation		2 000
Net profit for the year		4 000

Balance sheet at 31 March 2012

	£	£
Van		10 000
Less: Depreciation		2 000
		8 000
Stock	1 000	
Trade debtors	5 000	
Bank	12 500	
	18 500	
Less: Trade creditors	2 500	16 000
		24 000
Capital		20 000
Add: Net profit for the year		4 000
		24 000

Note: Starter commenced business on 1 April 2011.

Required:
(a) Compile Starter's cash flow statement for the year ended 31 March 2012.
(b) What does it tell the owners of Starter?

7.7 The following is a summary of Gregory Limited's accounts for the year ended 30 April 2010.

Profit and loss account for the year ended 30 April 2010

	£000
Net profit before tax	75
Taxation	25
	50
Dividend (proposed)	40
Retained profit for the year	10

Balance sheet at 30 April 2010

	30.4.09		*30.4.10*	
	£000	*£000*	*£000*	*£000*
Fixed assets				
Plant at cost		400		550
Less: Depreciation		100		180
	c/f	300		370

	30.4.09		*30.4.10*	
	£000	*£000*	*£000*	*£000*
b/f		300		370
Current assets				
Stocks	50		90	
Debtors	70		50	
Bank	10		2	
	130		142	
Less: *Current liabilities*				
Creditors	45		55	
Taxation	18		25	
Proposed dividend	35		40	
	98	32	120	22
		332		392
Capital and reserves				
Ordinary share capital		200		200
Profit and loss account		132		142
		332		342
Loans		–		50
		332		392

Additional information:
There were no sales of fixed assets during the year ended 30 April 2010.

Required:
(a) Prepare Gregory Limited's cash flow statement for the year ended 30 April 2010.
(b) Outline what it tells the managers of Gregory Limited.

7.8 The following summarized accounts have been prepared for Pill Limited:

Profit and loss account for the year ended 31 May 2011

	2010	*2011*
	£000	*£000*
Sales	2 400	3 000
Less: Cost of goods sold	1 600	2 000
Gross profit	800	1 000
Less: Expenses:		
Administrative expenses	310	320
Depreciation: vehicles	55	60
furniture	35	40
	400	420
Net profit	400	580
Taxation	120	150
	280	430
Dividends	200	250
Retained profits for the year	80	180

Balance sheet at 31 May 2011

	31.5.10		*31.5.11*	
	£000	*£000*	*£000*	*£000*
Fixed assets				
Vehicles at cost	600		800	
Less: Depreciation	200	400	260	540
Furniture	200		250	
Less: Depreciation	100	100	140	110
		500		650
Current assets				
Stocks	400		540	
Debtors	180		200	
Cash	320		120	
	900		860	
Less: Current liabilities				
Creditors	270		300	
Corporation tax	170		220	
Proposed dividends	150		100	
	590	310	620	240
		810		890
Capital and reserves				
Ordinary share capital		500		550
Profit and loss account		120		300
Shareholders' funds		620		850
Loans				
Debentures (10%)		190		40
		810		890

Additional information:
1 There were no sales of fixed assets during the year ended 31 May 2011.
2 The debentures were paid back at the beginning of the year.

Required:
(a) Compile Pill Limited's cash flow statement for the year ended 31 May 2011.
(b) What does it tell the managers of Pill Limited?

7.9 The following information relates to Brian Limited for the year ended 30 June 2012:

Profit and loss account for the year to 30 June 2012

	£000	*£000*
Gross profit		230
Administrative expenses	76	
Loss on sale of vehicle	3	
Increase in provision for doubtful debts	1	
Depreciation on vehicles	35	115
Net profit		115
Taxation		65
		50
Dividends		25
Retained profit for the year		25

Balance sheet at 30 June 2012

	2011		*2012*	
	£000	*£000*	*£000*	*£000*
Fixed assets				
Vehicle at cost		150		200
Less: Depreciation		75		100
		75		100
Current assets				
Stocks		60		50
Trade debtors	80		100	
Less: Provision for bad and doubtful debts	4	76	5	95
Cash		6		8
		142		153
Current liabilities				
Trade creditors	(60)		(53)	
Taxation	(52)		(65)	
Proposed dividend	(20)	(132)	(25)	(143)
		85		110
Capital and reserves				
Ordinary share capital		75		75
Profit and loss account		10		35
		85		110

Additional information:

1 The company purchased some new vehicles during 2012 for £75,000.
2 During 2012 the company also sold a vehicle for £12,000 in cash. The vehicle had originally cost £25,000, and £10,000 had been set aside for depreciation.

Required:

(a) Prepare a cash flow statement for Brian Limited for the year ended 30 June 2012.
(b) Outline what it tells the managers of Brian Limited.

Further practice questions, study material and links to relevant sites on the World Wide Web can be found on the website that accompanies this book. The site can be found at **www.pearsoned.co.uk/dyson**

Case study

Preparation of financial statements

Learning objectives

By the end of this case study you should be able to:

- identify the accounting rules adopted in preparing a set of accounts;
- evaluate the format and presentation of such accounts;
- suggest a more meaningful way of presenting them.

Background

Location Bleasedale

Personnel Alan Marshall: a member of the Calder Rambling Club
Wendy Hargreaves: Treasurer, Calder Rambling Club

Synopsis

Alan Marshall has recently joined the Calder Rambling Club based in Bleasedale. A few months after joining he attended the annual general meeting.

Among the items on the agenda was the treasurer's report. Alan did not know a great deal about accounting and so he was somewhat mystified by the 'accounts' presented by the treasurer, Wendy Hargreaves. He took the opportunity to ask her a few questions but he did not understand the explanations. A copy of the accounts as presented at the meeting is shown in the appendix to this case study. They were described as a 'balance sheet' and all the information was presented on one page.

After the meeting Alan learnt that Wendy had been in post for 25 years and the accounts had always been presented in that way. As long as the club had some money in the bank nobody else seemed concerned about them.

When he got home, Alan decided to write to Wendy asking for clarification about certain items contained in the 'balance sheet'. She was very helpful and she provided him with more information. He was still not satisfied that the accounts presented a clear picture of the club's financial position for the year 2010/11. He also suspected that this was probably true for the preceding year as well. Alan's questions and Wendy's answers are shown below.

A: *What is 'Mr Smith's bequest'*?
W: A legacy left by ex-chairman Arthur Smith to the club some years ago.

A: *On the left-hand side, what does the item 'Cheques not through bank' mean*?
W: Cheques that had not gone through the bank at the end of the year.

A: *On the right-hand side what do the 'Deposits' mean*?
W: The New Year deposit relates to a booking made at a youth hostel for the forthcoming New Year. The Slide Show deposit is a payment to the hotel for the room booking for the slide show in December.

A: *On the right-hand side, what does the item 'Through bank' mean*?
W: Cheques that had not gone through the bank at the beginning of the year.

A: *Were any amounts paid in 2009/10 for 2010/11*?
W: Yes – a deposit of £88 paid to the rugby club for the Christmas party held in December 2010.

A: *Did we receive any money in 2009/10 that related to 2010/11*?
W: Yes – subscriptions of £50 in total from five members.

***Required*:**

(a) Identify those accounting rules that the treasurer appears to have adopted in preparing the Calder Rambling Club's accounts and explain what each of them means.
(b) Giving your reasons, indicate what other accounting rules might be appropriate for the treasurer to adopt.
(c) Prepare the club's accounts in a format that you believe would more clearly present its financial performance and position during and at the end of the year.

Appendix

Calder Rambling Club
Balance sheet of accounts for year 2010/11

	£		£
Bank balance at 13.9.10	**4365**	Affiliation fees	20
Subscriptions	1920	Rights of Way membership	150
Donations	5	Mountain Hut membership	30
		Youth Hostel membership	6
Profits from:		Youth Hostel donation	100
Bus cancellation fees	406	National Trust donation	50
Private buses	144		
Christmas party	173	**Expenses:**	
Cheese and wine	17	Printing and stationery	330
		Leaders' expenses	16
Mr Smith's bequest	96	Recce expenses	1072
Bank interest (2010/11)	83	Postage/telephones	6
Subscriptions (2011/12)	30	Secretary	131
		Treasurer	36
		Sundry items:	
		Hire of halls	285
		Insurance	88
		General	42
		Deposits:	
		New Year 2011/12	128
		Slide show 16.12.11	50
		Losses:	
		High tea	5
		Lecture	17
		Through bank	297
Cheques not through bank	841	**Balance in bank 23.8.11**	5221
TOTAL	**£8080**	**TOTAL**	**£8080**

Case study

Accounting policies

Learning objectives

By the end of this case study you should be able to:

- outline the meaning of various conventional accounting policies used in preparing financial statements;
- explain the effect each policy has on the profit or loss for a particular period.

Background

Location Aberdeen

Personnel Clare Marshall: Potential investor
Kate Moorfield: Chartered Accountant

Synopsis

After leaving Birmingham University, Clare Marshall took up a marketing job in an Aberdeen oil firm. During her first five years with the company she earned a good salary and she was paid some highly satisfactory bonuses. She had managed to put a deposit down and take out a mortgage on a flat in Aberdeen, furnish it, buy a car and still have plenty of money for taking advantage of Aberdeen's amenities. She had also fallen in love with Scotland, and with a postgraduate student at Aberdeen University. So she was pretty certain that she would not be moving away from Scotland.

She had realized, however, that she might not always be earning a lot of money so she decided that she must start investing what little spare cash she had. She decided that as her future probably lay in Scotland she might as well invest in the country. Clare had taken a basic course in accounting when she was at university and her job gave her some knowledge of business life around the world, but she did not know very much about suitable companies in which to invest. So she decided to collect a number of Scottish companies' annual reports and accounts. They were delivered to her flat in dribs and drabs but eventually she was able to go through them all in detail.

It was hard going. Some of the reports were long and technical (especially and rather ironically, the oil company ones). However, one of the reports was from an Edinburgh-based construction company called J. Smart & Co. (Contractors) plc. Its 2008 report was only 50 pages long, so she started to go through it without feeling too daunted. But she found even this report hard going and she wished fervently that she had listened more carefully to her accounting lecturer when she was at university.

She got frustrated and bored, and so she decided to ring Kate Moorfield, one of the many new friends that she had made in Aberdeen. After they had discussed their respective boyfriends, Clare mentioned what she had been trying to do. Kate had recently passed her chartered accountancy examinations and she offered to go round to help Clare.

Kate was in her element. She took Clare through Smart's report pretty smartly, stressing what she said were two very important points:

- the preparation of accounting statements requires a great deal of individual judgement;
- apart from their relative brevity the format and content of Smart's accounts were no different from most other public companies.

Clare was reassured about the second point but concerned about accounts apparently needing a lot of 'individual judgement'.

'OK,' said Kate, 'let's look at Note 1 on pages 24 to 29. Rather interestingly they've called them accounting policies and *estimation* techniques. That makes my point. Apart from a few things that relate more to a construction company, they are pretty well what you will find in most reports.' Clare was beginning to feel a little less concerned.

Kate continued, 'If we go through a few of the policies, I can explain why some individual judgement is required and what impact the policies may have on the company's results.' 'How do you mean?' queried Clare. 'Are they flexible?' 'Oh yes,' replied Kate with the enthusiasm expected of a newly qualified chartered accountant. 'What do you mean exactly?' queried Clare rather anxiously. 'Now don't look so concerned,' said Kate, 'It's simply that depending on what accounting policies are adopted and what assumptions are made, it is possible to arrive at almost any figure for profit that you want. That is the case in the preparation of *any* accounting statement.'

Kate may have been overstating the point and Clare's face once more began to register alarm, so Kate began to explain the company's accounting policies while Clare listened very carefully. But it wasn't long before they decided to go out for a coffee and it was several weeks later before Clare bought some shares in ... well, we'd better not say.

***Required*:**

Some of Smart's accounting policies are outlined in the appendix to this case study.

(a) Explain what each of the accounting policies means.

(b) Demonstrate how the application of each these policies can affect the level of accounting profit (or loss) for a particular period.

Appendix

J. Smart & Co. (Contractors) plc
Accounting policies and estimation techniques

Basis of preparation

The accounts have been prepared under the historical cost convention.

The accounting policies set out below have been consistently applied to all periods presented in these accounts.

The preparation of financial statements requires management to make estimates and assumptions concerning the future that may affect the application of accounting policies and the reported amounts of assets and liabilities and income and expenses. Management believes that the estimates and assumptions used in the preparation of these accounts are reasonable. However, actual outcomes may differ from those anticipated.

Revenue

Revenue, which is stated net of value added tax, represents the invoiced value of goods sold, except in the case of long-term contracts where revenue represents the sales value of work done in the year.

Profits on long-term contracts are calculated in accordance with International Financial Reporting Standards and do not relate directly to revenue. Profit on current contracts is only taken at a stage near enough to completion for that profit to be reasonably certain after making provision for contingencies, whilst provision is made for all losses incurred to the accounting date together with any further losses that are foreseen in bringing contracts to completion.

The value of construction work transferred to investment properties is excluded from revenue.

Revenue from investment properties comprises rental income, service charges and other recoveries, and is disclosed as other operating income in the Consolidated financial statements.

Rental income from investment property leased out under an operating lease is recognized in the Income Statement on a straight-line basis over the term of the lease.

Surrender premiums from tenants vacating the property are deferred and released to revenue over the original lease term. When the unit is re-let all deferred amounts are released to revenue at that point.

Inventories and work in progress

Inventories are valued at the lower of cost and net realizable value.

Land held for development is included at the lower of cost and net realizable value.

Work in progress other than long-term contract work in progress is valued at the lower of cost and net realizable value.

Cost includes materials on a first-in, first-out basis and direct labour plus attributable overheads based on normal operating activity, where applicable. Net realizable value is the estimated selling price less anticipated disposal costs.

Long-term contracts

Amounts recoverable on contracts which are included in debtors are stated at cost as defined above, plus attributable profit to the extent that this is reasonably certain after making provision for maintenance costs, less any losses incurred or foreseen in bringing contracts to completion, and less amounts received as progress payments.

For any contracts where receipts exceed the book value of work done, the excess is included in trade and other payables as payments on account.

Depreciation

Depreciation is provided on all items of property, plant and equipment, other than investment properties including those under construction and freehold land, at rates calculated to write off the cost of each asset over its expected useful life, as follows:

Freehold building	over 40 to 66 years
Plant, machinery and vehicles	15% to $33\frac{1}{3}$% reducing balance or straight line as appropriate.

Case study

Cash flow statements

Learning objectives

By the end of this case study you should be able to:

- identify the main features of a published cash flow statement;
- evaluate the main reasons for changes in the cash position of an entity.

Background

Location Sidmouth

Personnel Edgar Glennie: a retired aircraft engineer
James Arbuthnot: a retired chartered accountant

Synopsis

Edgar Glennie retired from his job as an aircraft engineer in the early part of 2008. He moved to Sidmouth on the south coast and he now spends most of his time playing golf and reading the papers. The financial and political news had not been good and he was worried about his pension. During the five years leading up to his retirement he had managed to invest some savings in a number of companies from which he earned a small income but the market had collapsed and his shares were worth much less than he had paid for them.

As a shareholder he was used to receiving a copy of the annual report and accounts from his various shareholdings. He very rarely bothered to open the envelopes, never mind read the contents. More recently, as a result of his concerns, he had vowed to pay more attention to the progress of the companies in which he had invested. One of the first documents that he received following his vow was the 2008 annual report and accounts from Aggreko plc.

Edgar opened the report fairly gingerly. He did not know much about accounting and he was certain that he would not understand a word of what it was trying to tell him. However, he knew enough to realize that if the company made a profit he was likely to get a dividend but he also knew from the evidence of the 2007/09 recession that it had to have enough cash to keep going.

Aggreko's report was fairly thick – some 120 pages – but manageable as it was printed on A5-sized paper. Page 1 was the index which was useful. Where could he find out about the profit? There did not seem to be any mention of it. So he turned over to the next page where there was some useful information about 'Our Performance'. But he still sought futher detail. On page 4 he learned that Aggreko provided electrical power and temperature control to customers needing such services quickly or for an unknown period. Interesting but where were the details about profit?

He flicked over more pages and more pages until he got to page 71 – a page that did not have a lot on it. It appeared to be some sort of profit and loss account but it was

called a Group Income Statement. Ha! But it did give him the profit for the year: nearly £123 million compared with about £81 million for 2007. Good, now what about the dividend? There was no mention of it on that page.

He turned over to page 72: the Group Balance Sheet. This was a much longer statement but he did find an amount called 'cash and cash equivalents' (whatever they were) of £15.3 million compared with the previous year of £9.8 million. He wondered where all the profit had gone. Glancing at the opposite page he noticed that there was another statement called a 'Group Cash Flow Statement' but it showed 'cash and cash equivalents' of £10.3 million at the end of 2008 and £9.6 million at the end of 2007.

Realising that his own knowledge of accounting was too limited for him to sort it all out he decided to have a word with James Arbuthnot, a golfing friend of his. James had been a partner in a small firm of Chartered Accountants in Sidmouth until he had retired some years ago.

When Edgar telephoned James and told him what he had discovered James said that of course he would be glad to help him. Some days later they got together in the golf club bar and James began to take him through Aggreko's report and accounts. He began where Edgar had left off – at the Group Cash Flow Statement ...

***Required*:**

(a) The Aggreko' Group Cash Flow Statement for 2008 is shown in the appendix. Assume that you were James. Explain how a profit for the year after tax of £122.7 million only resulted in an increase in cash and cash equivalents of £10.3 million and why there appears to be a difference between the cash and cash equivalent balances on the group balance sheet and the group cash flow statement.

Appendix

Aggreko plc
Group cash flow statement for the year ended 31 December 2008

	2008 £*million*	*2007* £*million*
Cash flow from operating activities		
Cash generated from operations	276.1	230.2
Tax paid	(39.6)	(21.4)
Net cash generated from operating activities	236.5	208.8
Cash flows from investing activities		
Acquisitions (net of cash acquired)	(15.9)	(0.4)
Purchase of property, plant and equipment (PPE)	(265.2)	(180.6)
Proceeds from sale of PPE	9.0	8.1
Net cash used in investing activities	(272.1)	(172.9)
Cash flows from financing activities		
Net proceeds from sale of ordinary shares	1.3	1.8
Increase in long-term loans	185.7	66.0
Repayment of long-term loans	(107.1)	(62.6)
Net movement in short-term loans	4.9	(7.1)
Interest received	0.5	1.5
Interest paid	(14.6)	(12.8)
Dividends paid to shareholders	(23.7)	(19.2)
c/f	47.0	32.4

		2008 £million	2007 £million
	b/f	47.0	32.4
Purchase of Treasury shares		(13.2)	(4.2)
Sale of own shares by Employee Benefit Trust		0.9	–
Net cash from/(used in) financing activities		34.7	(36.6)
Net decrease in cash and cash equivalents		(0.9)	(0.7)
Cash and cash equivalents at beginning of year		9.6	10.0
Exchange gain on cash and cash equivalents		1.6	0.3
Cash and cash equivalents at end of year		10.3	9.6

Notes

(1) Cash flow from operating activities

	2008 £ million	2007 £ million
Profit for year	122.7	80.7
Adjustments for:		
Tax	67.3	43.5
Depreciation	115.9	92.8
Amortization of intangibles	1.9	1.6
Finance income	(0.5)	(1.5)
Finance cost	15.3	13.2
Profit on sale of PPE (see below)	(4.2)	(3.0)
Share-based payments	7.8	4.6
Changes in working capital (excluding the effects of exchange differences on consolidation):		
Increase in inventories	(20.4)	(18.6)
Increase in trade and other receivables	(51.7)	(13.4)
Increase in trade and other payables	23.8	34.7
Net movements in provisions for liabilities and charges	(1.8)	(4.2)
Net retirement benefit cost	–	(0.2)
Cash generated from operations	276.1	230.2

In the cash flow statement, proceeds from sale of PPE comprise:

	2008 £ million	2007 £ million
Net book amount	4.8	5.1
Profit on sale of PPE	4.2	3.0
Proceeds from sale of PPE	9.0	8.1

(2) Cash and cash equivalents

	2008 £million	2007 £million
Cash at bank and in hand	14.8	9.1
Short-term bank deposits	0.5	0.7
	15.3	0.7
Cash and cash equivalents *	15.3	0.7
Bank overdrafts +	(5.0)	(0.2)
	10.3	9.6

* as per the Group Balance Sheet

+ the bank overdrafts are included in the Group Balance Sheet under **Borrowings**