

## Cash Flow Statements

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**ABSTRACT** – *Financial statements are aimed at providing information that can be used by investors and creditors to forecast, compare and evaluate potential money in cash flows for their needs by the amount, the time schedule and the characteristic risks. The purpose of financial statements is to provide the beneficiaries with information to forecast, compare and evaluate the financial position, profit and loss levels and financial position changes, that is, the information on how the company acquired and spent the money, and on the company's debts and repayment of debts, and on the capital transactions, including payments of dividends and other distributions to the proprietors, as well as all other factors that influence the company's liquidity and ability to pay. This information should be useful to a wide circle of beneficiaries in the business decision-making process.*

*In their views of the purposes of financial statements, the International Accounting Standards Committee indicates that «economic decisions of financial statement beneficiaries require evaluation of the company's ability to produce cash and cash equivalents, as well as the time schedule and the certainty of their production,<sup>1</sup> pointing, naturally, to the basic financial statements, that is, the balance sheets, as financial statements on financial positions (Item 16), and the profit and loss balance, as the financial statements on the company's performance (Item 17), but also to the financial statements on the changes in the financial positions, primarily as financial statements (Item 18), the unsurpassable information sources for the forecast, the comparison, and the evaluation of the company by the beneficiaries.*

**KEY WORDS:** *Capital, cash flow, financial statements, decision-making process, investment*

### Basic categories of the financial statements

Financial statements are based on cash and cash equivalents, that is, money in cash flows and cash equivalents. By money, financial statements define money in the cash register and money on the giro and other bank accounts, including the overdraft on the bank accounts (International Accounting Standards – IAS-7, Items 6 and 8).

Cash equivalents are not money in a restricted sense as the aforementioned categories, but in this case they are short-term investments with the expiration date up to three months (IAS-7, Item 7). These are liquid or easily and swiftly cashable short-term investments. Item 7 of the International Accounting Standards says: «In order to characterise investments as cash equivalents, they should be swiftly replaceable by a defined amounts of money and they cannot bear any significant value changes».

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<sup>1</sup> International Accounting Standards Committee (IASC), Framework for Preparation and Presentation of Financial Statements, International Accounting Standards, London, 1997, Item 15.



## Purposes of developing financial statements

Financial statements are financial statements that are derived from the managerial need for additional information required for the decision-making process. At the global level today, the benefits from these statements are multiple, and even so great that they increasingly overshadow the information from the status balance and the profit and loss balance. External and internal beneficiaries of financial statements are interested in the information on the sources and methods of legal persons realising cash receipts, and what are the reasons for and what are the scopes of cash expenditures by various activities. The purposes of financial statements, that is to say, the benefits that these statements provide to external and internal beneficiaries, can be systemised in the following way:

- a) Legal persons evaluate potentials to accomplish future cash flows;
- b) To provide legal persons with the possibility to evaluate their liabilities to the creditors, to pay the dividends, and to evaluate the needs of legal persons for external financing;
- c) To provide evaluations of causes which differentiate the net profits from the net cash flows, and to provide correlations between cash receipts and cash expenditure;
- d) To provide evaluations of cash flows and various non-cash investments and financial activities influences on the financial position of the legal persons during the accounting period.

IAS-7 (Items 3, 4, and 5) say the following about the benefits from developing financial statements on cash flows:

1. Legal persons need money to manage their own businesses, to pay their liabilities and for the yield payments to their investors. Therefore, this Standard requires that all legal persons present their financial statements.
2. Financial statements provide information that beneficiaries can use to evaluate changes in legal person's net assets, their financial structure (including liquidity and ability to pay), and their ability to influence the cash flows amounts and the time schedule to accommodate to the changing circumstances and opportunities.
3. Information on cash flows makes it possible for legal persons to evaluate their abilities to produce cash and cash equivalents and for beneficiaries to develop models to evaluate and to compare current values of different legal person's future cash flows.
4. Financial statements increase comparability, which is used by different legal persons to develop statements on business profits and losses, because it eliminates the effects of different accounting procedures for the same business changes.
5. Historic information on cash flows is often used to indicate the amounts, the time frames and the certainty of future cash flows. It is additionally useful when checking the correctness of previous future cash flows evaluations and when exploring the correlations between the profitability and the net cash flow, and the influence of price changes.



## How to present financial statements

In accordance with the International Accounting Standard 7, financial statements are developed on the basis of three activity types of legal persons, and these are:

- a) Business activities;
- b) Investment activities;
- c) Financial activities.

Legal person's business activities are those activities that are primarily focused on the production and the sale of products and commodities, and the service provision. In other words, these are the activities that are not investments or financial activities. International Accounting Standard 7, Item 6, defines business activities in the following way: «Business activities are legal person's principal income-making activities, as well as other activities, with the exclusion of investments and financial activities».

On the side of expenditure, investment activities include legal person's investments in debtor's (bonds and other debts) and proprietor's (stocks) securities, as well as investments in other fixed assets (investments in equipment, real property and similar), as well as authorisation of loans, credits and similar. On the side of receipts, these activities include sales of investments in debtor's and proprietor's securities, as well as sales of fixed assets, refund equity authorised loans and similar. According to the International Accounting Standard 7 (Item 6), investment activities are «acquisition and alienation of fixed assets and other investments that are not included in the cash equivalents».

According to the International Accounting Standard 7 (Item 6), financial activities are «those activities that lead to changes of levels and compositions of legal person's personal capital and liabilities based on the loans taken». Specifically, financial activities on the side of receipts include acceptance of cash from the proprietors (stock emission) and, on the side of expenditure, cash refunds to proprietors on invested assets (dividends), as well as repurchases of stocks (acquisition of personal or treasury stocks). Additionally, financial activities on the side of receipts include legal person's debts (credits, emission of bonds) and, on the side of expenditure, debt refunds (this does not include the payments interest, which comes under the business activities).

## Influences of changes in capital, liabilities and non-cash assets on the financial situation changes

As investments and financial transactions, any business activity has their own direct influence on the balance, that is, on the legal person's financial situation. The most adequate baseline for the influence analysis of the changes developed on the balance, that is, the investments and the financial transactions; is the balance equation. During the period for which the balance is broken up, business activities influence the development of revenues and expenditures, and the difference between these two (net profit) represents a proportion of the capital (equity) in the balance. Additionally, in their finality, investments and financial activities have an influence on the assets, the liabilities and the capital status changes.

Influence of business, investment and financial activities can be presented in the following way by using the balance equation:

$$\text{ASSETS} = \text{LIABILITIES} + \text{CAPITAL}$$



The balance equation can be broken down and written as:

$$C + NCA = L + SE \quad (1)$$

where: C – cash and cash equivalents;

NCA – Non-cash assets;

L – Liabilities (long-term and short-term); and

SE – Share Capital.

Legal person's cash and cash equivalents are obtained by:

$$C = L + SE - NCA \quad (2)$$

Potential changes of cash and cash equivalents are the outcomes of changes in liabilities or in capital or in non-cash assets.

This is presented in the following way:

$$C = L + SE - NCA \quad (3)$$

Any given transaction, that is, the developed business changes, in the dual bookkeeping system subject to accounting records has for its consequence changes on the side of debts and claims at least on two accounting accounts. This means that the equation (3) can be explained in the following way:

Increase in cash and cash equivalents	=	Increase in liabilities	or	Increase in capital	or	Decrease in non-cash assets
Alternatively:						
Decrease in cash and cash equivalents	=	Decrease in liabilities	or	Decrease in capital	or	Increase in non-cash assets

However, any developed business change, as well as any investment or financial transactions, does not necessarily bear money features, that is, does not necessarily have cash receipts or expenditures as a consequence. Thus, for instance, payment of a single liability by an emission of other liabilities does not necessarily have to result with a decrease in cash and cash equivalents. Additionally, dividend payments in tangible assets (equipment, commodities) or by dividend stocks are not cash transactions, et cetera. The subjects of financial statements are only those business changes, and investment and financial activities, which for a consequence have receipts or expenditure cash and cash equivalents. Outcomes of analyses and transactions that are subjects to accounting records, and which have influence on cash and cash equivalents, should be coded by «P», «I», and «F» or by other codes adapted to computer data processing (business, investment and financial activities). In this way, legal persons will have a significantly easier job when developing financial statements.

### **Cash receipts and cash payments from business, investment and financial activities**

To develop financial statements, it is primarily necessary to define detailed cash receipts and cash expenditures by individual activities.



### **Cash receipts and cash payments from business activities**

These are cash receipts and cash payments from the principal business activity performed by a legal person:

- Sale for cash to buyers;
- Collection of claims from buyers;
- Received advances from operating activities;
- Receipts from collected interest, royalties, compensations, provisions;
- Cash refunds from the suppliers;
- Receipts from winning lawsuits in legal proceedings, penalties;
- Receipts from refunding, donations, subsidies and similar.

Cash payments are:

- Payments to employees for salaries and other;
- Payments to commodity suppliers and service providers;
- Payment of taxes and penalties;
- Cash expenditure for interest;
- Cash refunds to buyers (for defective or returned commodities and similar);
- Given advance payments for operational activities;
- Donations in cash and similar.

### **Cash receipts and cash payments from investment activities**

Cash receipts are:

- Receipts realised by the sale of tangible and intangible fixed assets;
- Receipts from the sale of proprietor's securities (stocks) or from the sale of investments in debtor's securities (bonds and similar);
- Receipts from the sale of debts;
- Receipts from investments (interest, dividends, shares, compensations and similar).

Cash payments are:

- Expenditure for the purchase of tangible and intangible fixed assets;
- Payments for investments in proprietor's securities or debtor's securities (bonds) and for the purchase of debts, financial placements and loans for other legal persons.

### **Cash receipts and cash payments from financial activities**

Cash receipts are:

- Cash receipts from emissions of proprietor's securities (stocks);
- Cash receipts from emissions of debtor's securities (bonds);
- Receipts from loans or credits received from financial institutions.

Cash payments are:

- Dividend payments and payments for repurchases of proprietor's (treasury) stock emissions;
- Payments for the repayment of loans or credits (equity only).



### **Cash flows from business, investment and financial activities according to the IAS-7**

IAS-7 does not specifically differentiate cash receipts and cash payments by individual activities, but gives a review of cash flows by business, investment and financial activities.

Cash flows from business activities (IAS-7, Item 14) are:

- a) «Cash receipts from the sale of commodities and service provision;
- b) Cash receipts from royalties, compensations, provisions and other revenues;
- c) Cash payments to the suppliers for commodities delivered and services provided;
- d) Cash payments to the employees and for the employee accounts;
- e) Cash receipts and cash payments from insurance companies, by way of premium and claim settlements, annuity and other benefits from insurance policy;
- f) Cash payments or tax refunds on profits except when these cannot be specifically related to financial and investment activities;
- g) Cash receipts and payments based on contracts concluded for the purposes of closing business deals or for the trading purposes».

Cash flows from investment activities contain the following (IAS-7, Item 16):

- a) «Cash payments for the acquisition of real property, plants and equipment, intangible assets and other fixed assets. The aforementioned payments include payments related to the capitalisation of development expenses and real property, plants and equipment building at one's own expenses;
- b) Cash receipts from the sale of real property, plants, equipment, intangible assets and other fixed assets;
- c) Cash payments for the acquisition of stock-holder's capital instruments and debtor's instruments of other legal persons and shares in joint ventures (except for payments for those basic instruments that are considered cash equivalents or for the instruments held for business and trading purposes);
- d) Cash receipts from the sale of stock-holder's capital instruments and debtor's instruments of other legal persons and shares in joint ventures (except for the payments for instruments that are considered cash equivalents or for the instruments kept for business and trading purposes);
- e) Cash advance payments and loans given to other persons (except for advance payments and loans given by financial institutions);
- f) Cash receipts from the repayments of advance payments and loans given to other persons (except for advance payments and loans from the financial institutions);
- g) Cash payments based on contracts for futures contracts, forward (deferred) contracts, option contracts and swaps (compensation contracts, except when these contracts are held with an intention to be trading with them or if the payments are presented as financial activities; and
- h) Cash receipts based on the futures contracts, deferred contracts, option contracts and swaps, except when these contracts are held with an intention to be trading with them or if the cash inflows are presented as financial activities».



Cash flows from financial activities (IAS-7, Item 17) are:

- a) «Cash receipts from the emission of stocks or from other instruments of stockholder's capital;
- b) Proprietor's cash payments for acquisition and stock repurchases from legal persons;
- c) Cash receipts from taking credits and loans, from issuing bills of exchange, from bond emissions, from taking mortgage credits and from other short-term or long-term loans;
- d) Cash repayments of loaned amounts; and
- e) Cash payments from leasing beneficiaries in the name of unsettled obligation reductions that are related to the financial leasing».

In IAS-7, financial statements do not give precise definitions of neither cash receipts nor expenditure for interest nor dividends. Thus, in IAS-7, Item 33 says the following: «Paid interest and received interest and dividends can be classified as cash flows from the business activities, since they are included in the definition of profits or losses. Alternatively, paid interest and received interest and dividends can be classified as cash flows from the financial activities or cash flows from the investment activities, because they represent expenses from the acquisition of financial assets or yields from investments».

However, American generally accepted accounting standards (US GAAP) give a precise definition of receipts and payments for interest, as well as dividends, which can be helpful in the classification of these receipts and payments. Receipts and payments from interest are classified under business activities. Receipts from dividends are classified under business activities, while payments for dividends are classified as financial activities.

### **Methods of developing financial statements**

There are two methods by which financial statements are developed, and these are the direct and the indirect methods (IAS-7, Item 18). According to the IAS-7, Item 19, legal persons are stimulated to develop financial statements by the direct method. This method provides beneficiaries with information that could be useful in the evaluation of future cash flows, which is not provided by the indirect method. Information on cash receipts and cash payments for developing financial statements by the direct method (IAS-7, Item 19) can be defined both:

- a) «From legal person's accounting records; and by
- b) Matching revenues from the sale and the expenses of products sold (in financial institutions, revenues from interest and similar revenues, and expenditure for interest and similar expenditures) and other items of the profit and loss balance for:
  - i. Changes in the supplies status and in claims and obligations from business operations, during the accounting period;
  - ii. Other non-cash items; and
  - iii. Other items, where monetary effects represent cash flows from investment and financial activities».



By indirect method and according to the IAS-7 (Item 20), statements on cash flows from business activities are developed by matching net profits or losses for the following effects:

- b) «Change in the supplies status and in claims and liabilities from business operations during the accounting period;
- c) Non-cash expenditures, such as: amortisation; reservation; differed taxes; unrealised positive and negative exchange rate differences; undistributed profits from attached companies and minority interests; and
- d) Any other item whose monetary effects represent cash flows from investment or financial activities».

Fundamental difference between these two methods is reflected in presenting cash flows from business activities:

**Direct method** present principal types of cash receipts and payments from business activities, and after that the sum, that is, the cash flows. Business individuals deciding for this method, in the segment of statements related to business activities will present a minimum of the following types of cash receipts and payments:

- a) Money in cash received from the buyers, including other cash receipts, for instance, advance payments, wages, and similar;
- b) Receipts from both interest and dividends;
- c) Other receipts from business activities;
- d) Cash payments to employees, tangible assets and commodities suppliers and service providers, including insurance and advertising companies and similar;
- e) Payments for interest;
- f) Payments for taxes;
- g) Other business activities based payments.

**Indirect method:** Cash flows from business activities are defined indirectly by matching, that is, adapting legal person's net profits with the effects from: a) changes, such as increase or decrease in supplies, claims and liabilities; b) amortisation of fixed assets, and revenues and expenditures from the sale of long-term assets (which are related to investment activities), as well as revenues and expenditures from allowance (of debts related to financial activities). In the indirect method, process of cleansing or recycling net profits on cash flows from business activities is frequently done by the following formula, according to the US GAAP (FASB), which is not in opposition with IAS-7:

Net profits (losses).

+ Amortisation of tangible fixed assets.

+ Amortisation of intangible fixed assets.

+ Amortisation of discount on emitted bonds.

- Amortisation of premium on emitted bonds.

+ Expenditure from the sale of tangible and intangible fixed assets.

- Incomes from the sale of tangible and intangible fixed assets.

+ Decrease in buyer's claims in business activities.





- Increase in claims from buyers in business activities (including claims for interest and dividends).
- + Decrease in supplies.
- Increase in supplies.
- + Increase in liabilities of the suppliers, as well as in other liabilities, such as: differed payments; salaries and wages liabilities; custom fees and taxes liabilities; interest liabilities (except for dividends liabilities that are included in the financial activities).
- Decrease in liabilities to the tangible assets and commodities suppliers and advance payments of expenses (active time differentiations), for instance, advance insurance payments, wages, advertisements and similar.
- + Decrease investments in branch offices (expenditures by sharing method).
- Increase in investments in branch offices (incomes by sharing method).
- = Cash flows from business activities.

If using the direct method, cash flows from business activities in Cash flow statements are then calculated in separate working notes by matching net profits. Contrary to the direct method, the indirect method makes the matching in the Cash flow statement framework.

### Example of developing financial statements based on the trial balance

On 31/12/2007, after making all entries in the books, Stock-holding Company «X» presented a trial balance that follows. Develop financial statements by direct and indirect method based on trial or gross balance. In the next section we shall present direct and indirect methods of developing flow statements.

*Trial balance for the «X» Stock-holding Company for the accounting period 01/01/2007 to 31/12/2007*

Account	Account title	Initial status		Turnover during the year		Turnover total		Balance on December 31	
		Debt	Claims	Debt	Claims	Debt	Claims	Debt	Claims
022	Equipment	17.000		2.000		19.000		19.000	
029	Correction of values		11.500	-	500		12.000	-	12.000
050	Shares in attached legal persons	14.000			1.000	14.000	1.000	13.000	
120	Finished products in storage	19.000	-	44.000	47.000	63.000	47.000	16.000	-
211	Buyers	13.000		69.000	64.500	82.000	64.500	17.500	
200	Giro account	11.500	-	11.500		23.000	-	23.000	-
400	Subscribed paid capital (nominal)		17.000		2.000	-	19.000		19.000
440	Accumulated profit		19.000	-	-	-	19.000	-	19.000



460	Profit in the current year	-	-	-	7.350	-	7.350	-	7.350
508	Liabilities for long-term credits	-	15.000	1.000	-	1.000	15.000	-	14.000
543	Suppliers	-	12.000	53.000	55.000	53.000	67.000	-	14.000
546	Liabilities for income taxes	-	-	-	3.150	-	3.150	-	3.150
600	Incomes from the sale of products	-	-	69.000	69.000	69.000	69.000	-	-
650	Expenses of the sold products	-	-	47.000	47.000	47.000	47.000	-	-
654	Management, sale and administration expenses	-	-	11.500	11.500	11.500	11.500	-	-
700	Difference between revenues and expenditure	-	-	10.500	10.500	10.500	10.500	-	-
	<b>TOTAL:</b>	<b>74.500</b>	<b>74.500</b>	<b>318.500</b>	<b>318.500</b>	<b>393.000</b>	<b>393.000</b>	<b>88.500</b>	<b>85.500</b>

*«X» Stock-holding Company – Financial statements on cash flow  
From 01/01/2007 to 31/12/2007 (By direct method)*

<b>A BUSINESS ACTIVITIES</b>		
1.	Cash receipts from the payment claims	64.500
2.	Cash payments for the paid liabilities to the suppliers	<u>(53.000)</u>
	Cash flows from the business activities	11.500
<b>B INVESTMENT ACTIVITIES</b>		
1.	Cash receipts from the sale of long-term investments	1.000
2.	Cash payments for equipment purchases	<u>(2.000)</u>
	Cash flows from investment activities	(1.000)
<b>C. FINANCIAL ACTIVITIES</b>		
1.	Cash receipts from stock emissions	2.000
2.	Cash payments for the partial equity repayment	<u>(1.000)</u>
	Cash flows from financial activities	1.000
	NET CASH FLOWS (A + B + C)	11.500
	CASH AT THE BEGINNING OF THE ACCOUNTING PERIOD	11.500
	CASH AT THE END OF THE ACCOUNTING PERIOD	23.000
	INCREASE (DECREASE) IN CASH	11.500

23.000 – 15.000



*Financial statements on cash flows*  
 «X» Stock-holding Company from 01/01/2007 to 31/12/2007  
 (By indirect method)

A	BUSINESS ACTIVITIES	
1.	Net profit	7.350
2.	Amortisation	500
3.	Decrease in claims from buyers	(4.500)
4.	Payment of liabilities to the suppliers	2.000
5.	Increase in liabilities for profit taxes	3.150
6.	Decrease in inventories	3.000
Cash flows from business activities		11.500

Investment and financial activities show no difference when compared to the direct method.

## Conclusion

Financial statements developed according to the IASB shows the cash inflows sources that the company received during the accounting period, and the purposes for which this money was used. Financial statements are the integral part of the business management analyses based on that they provide relevant information on cash assets management outcomes and information on the company's liquidity and ability to pay.

Specifically, this analysis provides relevant information for the evaluation of the company's profitability, assets reconstruction degrees and competitiveness degree in the financial abilities position. Additionally, many evaluation models use the money in cash flows from the regular business management as they provide the Management with motives to record cash inflows as cash inflows from regular business management and outflows developed either by investments or by financing.

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