Finsolve Accounting and Tax Solutions
Registered Accountants and Tax Practitioners

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Accounting talk

Cash Flow – the life blood of a business.

The Number one Rule: Profit is not Cash. (Remember Profit is an opinion, cash is fact!)

- The various accounting conventions we discussed previously allow for a number of accepted treatment of expenses and outflows of funds.
- Thus the income and expenses reflected on the Income Statement do not always reflect the actual underlying cash flows.
- The Cash Flow Statement is the link between the Statement of Financial Position and Income Statement and the underlying flow of funds.
- The Cash Flow Statement will reveal if the business has sufficient cash to finance its operations and its payments to various stakeholders, including Tax authorities and the Providers of capital.
- The Cash Flow Statement enables the Owner to answer questions such as:
- Does the business generate sufficient cash to cover all costs?
- Does the business generate sufficient cash to pay the owners of the business (drawings, dividends)?
- Does the business need to borrow funds to meet its cash shortfall?
- Is the business solvent?

The Cash Flow Statement reflects the underlying movements in cash, regardless of accounting treatment of the business.

Structure of the Cash Flow Statement

Profit before taxes and dividends
Add back noncash items – (Depreciation and provisions)
Add / (deduct) Working Capital Movement
➢ **Cash flow from Operating activities** ➢ **Investing activities** (purchase of PP&E and other long term investments) ➢ **Financing activities**
Net Increase / (Decrease) in Cash resources for the period

Operating cash flows

Cash generated from operations is a key figure in maintaining liquidity of a business. This figure can be derived from the statements using profit before tax, adjusted for:

i. Book entries, such as depreciation

ii. ii. Working capital movements

After adjusting for cash tied up in Working Capital, the resultant figure will determine the **cash generated from operations** – a key indicator of the business's pricing and cost control efficiency (or lack thereof).

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We measure the effectiveness of cash flow management by using the conversion ratio that of operating cash divided by operating profit.

The higher the %, the more liquid / efficient the company is in converting operating profits into operating cash.

A rule of thumb is for this figure to be 80% or greater.

Using Fast Foods (see cash flow statement below) as an example, find the operating cash flow figure, of $ 1,588k, and then compare this to the operating profit figure of Fast Foods, which is obtained from the income statement (module 3). This was recorded at $ 1,620k.

Comparing the two figures, we obtain cash conversion of 98% - excellent!

Investing cash flows

Cash invested in noncurrent assets, such as PP&E or Investment Property is recorded under this line item in the cash flow statement.

The company has to generate sufficient cash from operations to cover this spend in asset investment.

Financing cash flows

Financing activities of the business such as capital transactions with providers of capital (Banks and Owners), as well as any taxes and dividends paid re reflected here.

This will determine if shareholders are withdrawing cash out of the business in excess of its operational capacity.

Net Increase / (Decrease) in cash resources for the period

The resulting figure will expose if the business has added to, or reduced from, the opening balances of cash at the beginning of the period.

This is effectively the movement in opening and closing bank balances as reflected on the Statement of Financial Position.

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Fast Foods Pty Ltd

Statement of cash flows for the period ending 29 February 2012

	Notes	2012 USD	2011 USD
Cash flows from operating activities			
Cash generated by operations	8	2,031,473	2,011,422
Dividends paid		-	-
Normal tax paid		(494,497)	(297,650)
Net cash inflow / (outfllow) from operating activities	7	**1,588,014**	**1,713,772**
Cash flow from investing activities			
Purchase of property, plant and equipment		(1,804,316)	(389,622)
Proceeds from sale of equipment		-	-
Net cash outflow from investment activities		**(1,804,316)**	**(389,622)**
Cash flows from financing activities			
Increase / (Decrease) in shareholder's loan		233,614	(778,240)
Increase / (Decrease) in long term funding		(75,202)	(255,268)
Net cash inflow from financing activities		**158,412**	**(1,033,508)**
Net increase / (decrease) in cash and cash equivalents		(57,891)	290,642
Cash and cash equivalents at beginning of period		580,000	289,358
Cash and cash equivalents at end of period		**522,109**	**580,000**

Note that the company has generated some $ 1,588,014 in cash from operations, but required $1,804,316 to upgrade its equipment facilities, leaving a shortfall in cash of $ 216,302 which had to be funded from shareholders loans.

The link between the Statement of Financial Position and Income Statement

Notice how in creating the cash flow statement, the figures used in arriving at cash flow, are obtained from both the Statement of Financial Position and the Income Statement – thus it forms the link between the two statements.

Remember, the Financial Position, and the Income Statement reflects accrual accounting, while the cash flow statement reflects cash movements.

Use the cash flow statement as the reconciliation of the movement in bank / cash balances from one period to the next ie from one year end to the next. Just because the bank balance as reflected on the Financial Position has increased over the prior year, does not indicate good cash management, but could simply be because shareholders have injected additional cash into the business and have nothing to do with improved management of operations! In Fast Foods above, Bank balances declined year on year, as a result of the additional capital spend which exceeded the cash generated from operations.