COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | BASIC

Video Transcription: Statement of Cash Flows – Introduction

UCT College of Accounting

Hi, my name is Don Macdonald and in this video we are going to introduce the principles underlying the Statement of Cash Flows, and in a further video we are looking at the Statement of Cash Flows in a little more detail. You are already familiar with the four financial statements that are the Statement of Financial Position, the Statement of Comprehensive Income and the Statement of Changes in Equity that is in addition to the Statement of Cash Flows. Well, the Statement of Cash Flows is the only statement, which relies totally on the cash inflows and the cash outflows. The other three financial statements are all prepared using the accrual basis of accounting. What I would like to do is look at the Statement of Financial Position first and particularly the cash and cash-equivalent amounts. We can see that there are two balances, one for the current year and one for the prior year. What we want to understand is what has caused the change between the two years. Users of financial statements are particularly interested in the details of these changes.

These changes are caused by the difference between the cash inflows and the cash outflows. So, where do we get the details of these flows of cash? Well, the obvious answer is to do an analysis of the bank account, which is prepared in the accounting records of the business. Once we have analysed the bank account we can then break down the differences between the various activities of a business: the operating activities, the investing activities and the financing activities.

But, is this the best way of doing it? Well, no. It is very time-consuming to analyse the bank account, and in many businesses there are a large number of business transactions that go through the bank. And also, it would not be cost effective.

So how do we do this? Well, we need to use the numbers available in the financial statements, which are being prepared using the accrual basis of accounting. What we can do then is to unpack the accruals in order to establish the cash flows. Let us look at some cash flows arising from each of the business activities. We will firstly consider an example of an operating activity, secondly an investing activity and then we will look at two financing activities, and finally we will return to an example of an operating activity. So, let's start with one of the key operating activities in the Statement of Cash Flows. Namely, the cash received from customers.

So how do we establish the amount of cash received from customers? Well, what we need to do is look at the amounts, which were calculated using the accrual basis of accounting. Then we can unpack those accruals in relation specifically to sales made to customers. So, by unpacking the accruals we will be able to establish how much cash was actually received from customers during the year. So, let's calculate how much cash could come into the business during the current year. Firstly, we would need the total sales for the year and we will add the amounts that have not yet been paid at the beginning of the year. If we add those two together we will get the total amount of cash that could be received during the year. If we then deduct the amounts owing by customers at the end of the year we will actually have established the amount of cash received during the current year from our customers. This amount will appear in the operating activities, in the Statement of Cash Flows.

We will come back to the operating activities with another example. But let's move on to the investing activities. There is a separate section in the Statement of Cash Flows for such activities and we will look, particularly, at the acquisition of some "property, plant and equipment".

In preparing the Statement of Cash Flows what we are really interested in is how much cash was actually paid for the "property, plant and equipment" that we are buying. Because any "property, plant and equipment" that we acquire during the year does not necessarily mean that we have paid for it.

So, what we need to do is establish, out of the payables amount at the beginning of the year and the payables at the end of the year, what portion of that relates to the acquisition of "property, plant and equipment". Because then what we are going to do is take the purchase during the year, add the amount that was outstanding at the beginning of the year in respect of "property, plant and equipment" purchases, and deduct what we have not yet paid at the end of the year; by doing that, we actually establish the amount of cash that was paid to suppliers of "property, plant and equipment" during that year.

In order to pay for the "property, plant and equipment", the business could have obtained financing and we could have either borrowed the money from lenders or the company could have issued some more shares. Both would have resulted in an inflow of cash. So if we look at the Statement of Cash Flows, we will see an inflow of cash resulting from the financing activity and then an outflow of cash resulting from the investing activity when we acquired the "property, plant and equipment".

Having briefly explained the financing and investing activities, we are now going back to an operating activity, and we are going to look at the payments to the suppliers of inventory. The amount recognised in the Statement of Comprehensive Income i.e. the cost of sales, does not represent the amount that was purchased during the year but rather the inventory that was consumed in generating those sales.

So how do we establish the cost of purchases made during the year? Well, we know that the cost of sales is made up of your opening inventory plus your purchases and by deducting your closing inventory. So if we are given the cost of sales, we could reverse that process in order to calculate the cost of purchases made during the year.

But remember, once we have established the cost of purchases that are on the accrual basis, what we need to do is to unpack the accruals in order to establish the amount of cash that was paid to suppliers of the inventory that we have purchased. What should be clear by now is that we have had to unravel information, which has been prepared using the accrual basis of accounting in order to find out what cash flows have taken place during the year.

A key point to remember is that items that have actually been received or paid during the year appear in the Statement of Cash Flows. And, although we have unpacked accruals in order to establish these amounts, if it does not involve a movement of cash, it should not appear in the Statement of Cash Flows. Hopefully, by now, you have realised that the Statement of Cash Flows does exactly what it says it does. It reflects the flow of cash into the business and the flow of cash out of the business. In order to establish these cash flows we have had to unpack the accruals from the information that were prepared using the accrual basis of accounting. I look forward to joining you in the next video when we will look at the Statement of Cash Flows in a little bit more detail.

See you then.