IAS 7, Statement of Cash Flows – A Closer Look

Muthupandian, K S

The Institute of Cost and Works Accountants of India

22 August 2008

IAS 7, Statement of Cash Flows – A Closer Look

K.S.Muthupandian*

In June 1976, the International Accounting Standards Committee (IASC) issued the Exposure Draft E7, *Statement of Source and Application of Funds*. In October 1977, the IASC issued IAS 7, *Statement of Changes in Financial Position.* In July 1991, the IASC issued Exposure Draft E36, *Cash Flow Statements.* Based on the comments received, the IASC issued revised IAS 7, *Cash Flow Statements* in December 1992, which supersedes 1977 version of IAS 7. The effective date was fixed as January 1, 1994. On September 6, 2007, the International Accounting Standards Board (IASB) changed the title of IAS 7 from *Cash Flow Statements* to *Statement of Cash Flows* as a consequential amendment resulting from revisions to IAS 1, *Presentation of Financial Statements.*

Objective

The objective of IAS 7 is to require the presentation or provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a statement of cash flows, which classifies cash flows during the period according to operating, investing, and financing activities. Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

***M.Com., AICWA and Member of Tamil Nadu State Treasuries and Accounts Service, presently working as Treasury Officer, Ramanathapuram District, Tamil Nadu. Email: ksmuthupandian@yahoo.co.in**

Scope

An enterprise should prepare a statement of cash flows in accordance with the requirements of this Standard and should present it as an integral part of its financial statements for each period for which financial statements are presented. Users of an enterprise’s financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise’s activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial institution. Enterprises need cash for essentially the same reasons however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors. Accordingly, IAS 7 requires all enterprises to present a statement of cash flows.

Definitions

Cash flows are inflows and outflows of cash and cash equivalents. **Cash** comprises cash on hand and demand deposits. **Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Fundamental Principle in IAS 7

All enterprises that prepare financial statements in conformity with IFRSs are required to present a statement of cash flows. The statement of cash flows analyses changes in cash and cash equivalents during a period. Cash and cash equivalents comprise cash on hand and demand deposits, together with short-term, highly liquid investments that are readily convertible to a known amount of cash, and that are subject to an insignificant risk of changes in value. Guidance notes indicate that an investment normally meets the definition of a cash equivalent when it has a maturity of three months or less from the date of acquisition. Equity investments are normally excluded, unless they are in substance a cash equivalent (e.g. preferred shares acquired within three months of their specified redemption date). Bank overdrafts which are repayable on demand and which form an integral part of an enterprise's cash management are also included as a component of cash and cash equivalents.

Classification of cash flows

The statement of cash flows shall report cash flows during the period in the following classification:

(1) **Operating activities:**
(2) **Investing activities:**
(3) **Financing activities:**

A model statement of cash flows is given as annexure.

Operating activities

Operating activities are the main revenue-producing activities of the enterprise and other activities that are not investing or financing activities, so operating cash flows include cash received from customers and cash paid to suppliers and employees. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing.

Examples of cash flows from operating activities are:
(a) cash receipts from the sale of goods and the rendering of services;
(b) cash receipts from royalties, fees, commissions and other revenue;
(c) cash payments to suppliers for goods and services;
(d) cash payments to and on behalf of employees;
(e) cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
(g) cash receipts and payments from contracts held for dealing or trading purposes.
Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

An entity shall report cash flows from operating activities using either:

(a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

Direct Method

The direct method shows each major class of gross cash receipts and gross cash payments. The operating cash flows section of the statement of cash flows under the direct method would appear something like this:

Cash receipts from customers	xxx
Cash paid to suppliers	xxx
Cash paid to employees	xxx
Cash paid for other operating expenses	xxx
Interest paid	xxx
Income taxes paid	xxx
Net cash from operating activities	**xxx**

Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:
(a) from the accounting records of the enterprise; or
(b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the income statement for:
(i) changes during the period in inventories and operating receivables and payables;
(ii) other non-cash items; and
(iii) other items for which the cash effects are investing or financing cash flows.

Indirect Method

The indirect method adjusts accrual basis net profit or loss for the effects of non-cash transactions. The operating cash flows section of the statement of cash flows under the indirect method would appear something like this:

Profit before interest and income taxes		xxx
Add back depreciation		xxx
Add back amortisation of goodwill		xxx
Increase in receivables		xxx
Decrease in inventories		xxx
Increase in trade payables		xxx
Interest expense	xxx	
Less Interest accrued but not yet paid	xxx	
Interest paid		xxx
Income taxes paid		xxx
Net cash from operating activities		**xxx**

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:
(a) changes during the period in inventories and operating receivables and payables;
(b) non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, undistributed profits of associates, and minority interests; and
(c) all other items for which the cash effects are investing or financing cash flows.
Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the revenues and expenses disclosed in the income statement and the changes during the period in inventories and operating receivables and payables.

Investing activities

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units shall be presented separately and classified as investing activities.

Examples of cash flows arising from investing activities are:
(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;
(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;
(c) cash payments to acquire equity or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);
(d) cash receipts from sales of equity or debt instruments of other enterprises and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
(e) cash advances and loans made to other parties (other than advances and loans made by a financial institution);
(f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);
(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

Financing activities

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity.

Examples of cash flows arising from financing activities are:
(a) cash proceeds from issuing shares or other equity instruments;
(b) cash payments to owners to acquire or redeem the enterprise's shares;
(c) cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings;
(d) cash repayments of amounts borrowed; and
(e) cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

Presentation of the Statement of Cash Flows

Key principles specified by IAS 7 for the preparation of a statement of cash flows are as follows:

Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation.

An entity shall report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities.

Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows. Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Interest and dividends received and paid may be classified as operating, investing, or financing cash flows, provided that they are classified consistently from period to period

Cash flows arising from taxes on income are normally classified as operating, unless they can be specifically identified with financing or investing activities

For operating cash flows, the direct method of presentation is encouraged, but the indirect method is acceptable

Foreign currency cash flows

Cash flows arising from transactions in a foreign currency shall be recorded in an entity's functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow. The cash flows of a foreign subsidiary shall be translated at the exchange rates between the functional currency and the foreign currency at the dates of the cash flows. Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period.

Disclosures

An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the balance sheet.

There are various circumstances in which cash and cash equivalent balances held by an enterprise are not available for use by the group. Examples include cash and cash equivalent balances held by a subsidiary that operates in a country where exchange controls or other legal restrictions apply when the balances are not available for general use by the parent or other subsidiaries.

Additional information may be relevant to users in understanding the financial position and liquidity of an enterprise. Disclosure of this information, together with a commentary by management, is encouraged and may include:

(a) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities;

(b) the aggregate amounts of the cash flows from each of operating, investing and financing activities related to interests in joint ventures reported using proportionate consolidation;

(c) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity; and

(d) the amount of the cash flows arising from the operating, investing and financing activities of each reported industry and geographical segment.

The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the enterprise is investing adequately in the maintenance of its operating capacity. An enterprise that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

Reporting Cash Flows On A Net Basis

Cash flows arising from each of the following activities of a financial institution may be reported on a net basis:
(a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;
(b) the placement of deposits with and withdrawal of deposits from other financial institutions; and
(c) cash advances and loans made to customers and the repayment of those advances and loans.

Cash flows from investing and financing activities should be reported gross by major class of cash receipts and major class of cash payments except for the following cases, which may be reported on a net basis:
*cash receipts and payments on behalf of customers (for example, receipt and repayment of demand deposits by banks, and receipts collected on behalf of and paid over to the owner of a property)
*cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short, generally less than three months (for example, charges and collections from credit card customers, and purchase and sale of investments)
*cash receipts and payments relating to fixed maturity deposits
*cash advances and loans made to customers and repayments thereof

Conclusion

IAS 7 permits the comparison of the information on the performance of various companies because it eliminates the effect of using diverse accounting procedures for the same transactions and economic events.

Appendix
Statement of Cash Flows for Year Ended 31 March …..

Cash flows from operating activities:	
Net profit before tax	-
Adjustment for:	
Depreciation	-
Profit/loss on sale non-current assets	-
Interest expense	-
Operating profit before working capital changes	-
*Increase in inventory	-
*Increase in receivables	-
*Increase in payables	-
Cash generated from operations	-
Interest paid	-
Dividends paid	-
Tax paid	-
Net cash flow from operating activities	-
Cash flows from investing activities:	
Purchase of non-current assets	-
Proceeds of sale non-current assets	-
Net cash used in investing activities	-
Cash flows from financing activities:	
Proceeds, issue of shares	-
Proceeds, issue of 10% loan notes (also redemption)	-
Net cash flow from financing activities	-
Net increase in cash and cash equivalents	-
Cash and cash equivalents 1 April ….	-
Cash and cash equivalents 31 March …..	-