THE RELATIONSHIP BETWEEN PROFITABILITY & THE GENERATION OF CASH

			Lm
WEEK 1	Starts business with:	Motor car	2,500
		Stock	500
		Cash	500
	Sells all stock on one month's credit		700
WEEK 2	Buys stock on two weeks' credit		1,000
	Sells all stock on one month's credit		1,500
	Pays expenses		100
WEEK 3	Buys stock on two weeks' credit		2,000
	Sells all stock on one month's credit		3,000
	Pays expenses		300

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		Lm
WEEK 4	Obtains loan (repayable Lm1,000 per week)	6,500
	Buys stock on two weeks' credit	3,000
	Sells all stock on one month's credit	4,400
	Pays expenses	400
	Buys another car	5,000
	Pays week 2 creditors	1,000
WEEK 5	Buys stock on two weeks' credit	5,000
	Sells all stock on one month's credit	7,000
	Pays expenses	800
	Pays income tax	700
	Receives cash from week 1 debtors	700
	Pays week 3 creditors	2,000
	Pays loan instalment	1,000

Balance Sheet	**1**	**2**	**3**	**4**	**5**
Motor cars	2,500	2,500	2,500	7,500	7,500
Debtors	700	2,200	5,200	9,600	15,900
Cash	500	400	100	200	0
	3,700	**5,100**	**7,800**	**17,300**	**23,400**
Financed by:					
Capital	3,500	3,500	3,500	3,500	3,500
Profit (after tax)	200	600	1,300	2,300	2,800
	3,700	**4,100**	**4,800**	**5,800**	**6,300**
Loan	0	0	0	6,500	6,400
Creditors	0	1,000	3,000	5,000	8,000
???????					2,700
	3,700	**5,100**	**7,800**	**17,300**	**23,400**

Profit & Loss	**1**	**2**	**3**	**4**	**5**	Total

Sales	700	1,500	3,000	4,400	7,000	16,600
Purchases	(500)	(1,000)	(2,000)	(3,000)	(5,000)	(11,500)
Gross profit	200	500	1,000	1,400	2,000	5,100
Expenses	0	(100)	(300)	(400)	(800)	(1,600)
Net profit	**200**	**400**	**700**	**1,000**	**1,200**	**3,500**
Profitability ratios	%	%	%	%	%	
Gross profit margin	29	33	33	32	29	
Net profit margin	29	27	23	23	17	
Return on owner's capital	5	10	15	17	19	

Cash flow	**1**	**2**	**3**	**4**	**5**
Receipts:					
Debtors	0	0	0	0	700
Payments:					
Creditors	0	0	0	1,000	2,000
Expenses / tax	0	100	300	400	1,500
Fixed assets	0	0	0	5,000	0
	0	100	300	6,400	3,500
Net cashflow	0	(100)	(300)	(6,400)	(2,800)
Bal b/f	500	500	400	100	(6,300)
Bal c/f	500	400	100	(6,300)	(9,100)

In the long run, the survival and growth of a business will depend on its ability to GENERATE CASH.

A statement showing INFLOWS & OUTFLOWS OF CASH is an integral part of the financial statements of an enterprise.

CASH FLOW STATEMENT - IAS 7

The Cash Flow Statement

Covers a financial period and shows how cash flow generated has been used within the business, or how the business has coped with a net outflow of cash

determines the relationship between profitability and net cash flow - evaluates the QUALITY of profit earned

provides users of financial statements with a basis to assess the ability of the enterprise to generate cash

gives information on the timing and certainty of the generation of future cash flows

The Cash Flow Statement analyses changes in an enterprise's holdings of CASH and CASH EQUIVALENTS

- **CASH**

  Cash in hand & deposits repayable on demand

- **CASH EQUIVALENTS**

  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

IAS 7 - CASH FLOW STATEMENTS

IAS 7 requires the cash flows of an enterprise to be disclosed under 3 headings:

- OPERATING ACTIVITIES
- INVESTING ACTIVITIES
- FINANCING ACTIVITIES

1 OPERATING ACTIVITIES

= the principal revenue-producing activities of the enterprise, and other activities that are not investing or financing activities. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to repay loans, maintain the operating capability of the enterprise, pay dividends and make new investments without recourse to external sources of financing

→ **This is the cash generated by the *core activities* of the enterprise**

1 OPERATING ACTIVITIES (cont.)

Cash flow from operating activities may be disclosed using either the DIRECT or the INDIRECT method

IAS 7 recommends the DIRECT method, whereby major classes of gross cash receipts and gross cash payments are disclosed:

CASH RECEIVED FROM CUSTOMERS

add

CASH PAID TO SUPPLIERS AND EMPLOYEES

less

INTEREST PAID

less

TAX PAID

1 OPERATING ACTIVITIES (cont.)

Under the INDIRECT method, net cash flow from operating activities is determined by adjusting net profit/loss for the effects of:

Changes during the period in stocks, debtors & creditors

Other non-cash items

Other items classified under investing or financing cash flows

	PROFIT BEFORE TAX AND INTEREST
add	**DEPRECIATION**
less	**PROFIT ON DISPOSAL OF FIXED ASSETS**
less	**INCREASE (+ decrease) IN STOCKS**
less	**INCREASE (+ decrease) IN DEBTORS**
add	**INCREASE (*less* decrease) IN CREDITORS**

2 INVESTING ACTIVITIES

= Acquisition & disposal of long-term assets and investments not included in cash equivalents. These cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows

Examples of investing activities

- purchase or sale of fixed assets (incl. capitalised development costs)
- purchase or sale of equity or debt instruments of other enterprises
- advances & loans made to, or repaid by, other parties
- cash payments or receipts for/from futures, forwards, options & swaps (except when these are held for trading purposes)

3 FINANCING ACTIVITIES

= Activities that result in changes in the size & composition of the equity capital and borrowings of the enterprise. They are useful in predicting claims on future cash flows by providers of capital to the enterprise

Examples of financing activities

- proceeds of issue or redemption of the enterprise's equity
- proceeds of issue or redemption of the enterprise's debentures & other borrowings
- cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease

OTHER ITEMS

Foreign currency cash flows	use exchange rate at the date of cash flow (or use average rates)
Extraordinary items	disclose separately under appropriate classification
Interest & dividends	disclose separately under appropriate classification
Taxes on income	disclose separately under *operating*
Investments in subsidiaries, associates and joint ventures	Equity - report cash flows with investee Consolidation - report proportionate share
Acquisitions & disposals of subsidiaries and other business units	disclose separately under *investing*
Non-cash transactions	Exclude

CASH FLOW STATEMENT - EXAMPLE

Profit & Loss Account of Freshwater Ltd for the year ended 31 December 1997

		Lm
	Sales	125,320
less	Cost of sales	(75,992)
	Gross profit	49,328
less	Administrative expenses	(26,744)
	Depreciation	(9,035)
	Operating profit before tax	13,549
	Interest received	13,122
	Profit before tax	26,671
	Tax	(9,355)
	Profit after tax	17,316
	Dividend paid	(10,000)
	Transfer to reserves	(6,000)
	Retained profit for year	1,316
	Balance b/f	7,940
	Balance c/f	9,256

Balance Sheet of Freshwater Ltd as at 31 December 1997

		97			96	
	Lm	Lm	Lm	Lm	Lm	Lm
Fixed assets	83,440	(33,340)	50,100	81,350	(24,305)	57,045
Investments			172,110			157,331
Current assets: Stock	6,405			5,803		
Debtors	10,487	16,892		8,566	14,369	
less						
Current liabs: Creditors	8,195			6,255		
Tax	250			120		
Bank o/d	5,401	13,846		4,430	10,805	
Net current assets			3,046			3,564
Net assets			225,256			217,940
Financed by:						
Ordinary share capital			200,000			200,000
Reserves			16,000			10,000
Profit & loss account			9,256			7,940
Capital employed			225,256			217,940

Cash Flow Statement of Freshwater Ltd for the year ended 31 December 1997

	Lm	
Cash flow from operating activities		
Cash receipts from customers	123,399	(B/f 8,566 + Sales for year 125,320 - c/f 10,487)
Cash paid to suppliers & employees	(101,398)	(B/f 6,255 + Purchases for yr 76,594 - c/f 8,195) + expenses
Cash generated from operations	22,001	
Tax paid	(9,225)	(B/f 120 + Charge for year 9,355 - c/f 250)
Net cash from operating activities	12,776	
Cash flow from investing activities		
Interest received	13,122	Profit & loss
Purchase of tangible fixed assets	(2,090)	Bal sheet - assume no disposals
Purchase of investments	(14,779)	
Net cash from investing activities	(3,747)	
Cash flow from financing activities		
Dividend paid	(10,000)	Appropriation account
Net increase in cash & cash equivalents	(971)	Grand total of the three classifications
Cash & cash equivalents at 31 Dec 96	(4,430)	Bank balance b/f
Cash & cash equivalents at 31 Dec 97	(5,401)	Bank balance c/f

= Cost of sales 75,992

+ Cl stock 6,405

- Op stock 5,803

Cash Flow Statement of Freshwater Ltd

Under the indirect method, operating cash flow would be shown as follows:

		Lm
	Net profit before tax and interest	13,549
add	Depreciation	9,035
	Operating profit before working capital changes	22,584
	Adjustments for:	
	Increase in stocks	(602)
	Increase in debtors	(1,921)
	Increase in creditors	1,940
	Cash generated from operations	22,001
	Tax paid	(9,225)
	Net cash from operating activities	12,776