

ANALYSIS OF CASH FLOWS AND PROFIT & LOSS STATEMENTS , INTERCONNECTIONS AND DIFFERENCES BETWEEN THEM

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Even though three main financial statements : Statement of Cash Flows, Income Statement and Balance Sheet each of them contain very distinct information, they are completely connected. In fact, you can't produce a balance sheet without first creating a statement of profit and loss (P & L statement) , and you can't prepare a statement of cash flows without having already produced the other two financial statements. Below we would like to analyze the statement of cash flows(IAS 7) and the statement of Profit and Loss(IAS 1-revision) in detail in conjunction with each other.

Some Readers of a company's financial statements might be misled by a reporting profit figure in the statement of Profit and Loss (P & L). However paying dividends or wages in reality depends on liquidity or cash flows. The Statement of Profit and Loss is based on accruals principle, while cash itself is important for preparing the Statement of Cash flows. Firstly, Share holders might believe that if a company has a profit after tax , for example 50 000 Gel, this amount could be afford to pay it out as dividends. Unless the company has enough cash to stay in business and also to pay dividend, the shareholders' expectations would be wrong and disappointing. Secondly, employers believe that referring a high profit figure in P & L Statement, it is possible to get paid higher wages, this is also incorrect: the ability to pay wages or debts or dividends depends on availability of cash. The aim of IAS 7 is to provide information to users about the company's ability to generate cash and cash equivalents.

This statement¹ will cover the same period as the statement of profit and loss. It starts with the beginning cash balance for the period (which is

1 <http://www.netplaces.com/accounting/preparing-financial-statements/the-statement-of-cash-flows.htm>

the same as the ending cash balance for the last period). Then, there are three categories (formatted on the report as separate sections) that track the cash flowing through a company: operating activities, investing activities, and financing activities.

Operating activities include all the day-to-day transactions that bring in or use up cash; mainly, revenues and expenses. This section differs according to the method that will be chosen: direct or indirect; this will be discussed below in detail.

Investing activities include buying and selling fixed assets , stocks and bonds , property improvements (for example, paying to have a building renovated).

Financing activities include the things you do to raise cash for your company, such as taking out loans or bringing in more equity contributions; they also include the payments you make as you pay down debt or pay out dividends.

Of the three sections, operating activities is the most important. This category speaks to how successfully your business maintains a positive cash position solely through its daily transactions. If your company is generating enough cash to survive from its operating activities, its means it can stay in business and continue operating.

The standard offers 2 methods for reporting cash flows:

1) Direct method¹: disclose gross cash receipts and payments; It focuses on grouping the major sources of cash receipts and causes of cash payments. For example, cash used to pay to suppliers for inventory is listed separately from cash used to pay employees.

2) Indirect method² : Net profit or loss is adjusted for the effects of a non-cash nature, any deferrals or accruals of past or future operating receipts or payments, and items of income or expenses associated with investing or financing flows. For example, non-cash expenses such as depreciation are added back to the bottom-line number, and accruals and

¹ ACCA-F7- Financial Reporting (International and United Kingdom)-Study Textbook

² ACCA-F7- Financial Reporting (International and United Kingdom)-Study Textbook

deferrals (used in accrual basis accounting) are converted into their cash effect. Here's how a conversion works: A decrease in accounts receivable from the period prior to this one indicates more cash has come in, since accounts receivable decreases based on customer payments. That converts on-account sales information into the cash effect for this period. The basic conversion strategy is this: Increases in liabilities, such as accounts payable, translate to increases in cash-not paying off debts, and vice versa; Increases in assets, such as accounts receivable(not receiving cash), inventory(paying cash for buying them) translate to decreases in cash, and etc.¹ Remember, the bottom line on the statement of cash flows — your cash at the end of the period — must equal the cash figure on your current balance sheet. Moreover, it should be explained in detail why some items are added and others subtracted in the Statement of Cash flows:

1) Depreciation -as a non-cash item but is deducted during calculating profit in P&L Statement. Therefore, to eliminate it is necessary to add back.

2) A loss on disposal of a non-current asset as it was already deducted from profit now here it needs to be added back.

3) An increase in Inventories -means having spent much money on buying inventory-thus less cash.

4) An increase in receivables- you have not still received money from your customers-thus less cash.

5) Increase in Liabilities- you paid off your debts-thus less cash logically and etc.

Below you can see 2 different operating activities section using different methods (see images):

As an example of the often used complete Statement of Cash flows generally can be like this:

The balance sheet is sort of the financial statement middleman. It pulls information from the statement of profit and loss and offers information to the statement of cash flows. As you might guess, the statement of cash flows needs to know how much cash the company started the period with,

1 <http://www.netplaces.com/accounting/preparing-financial-statements/the-statement-of-cash-flows.htm>

DIRECT METHOD		
Cash Flows from Operating Activities		
Cash Receipts		
Cash collections from customers	\$782,000	
Interest on investments and loans	<u>1,000</u>	
Total Cash Receipts		\$783,000
Cash Payments		
Merchandise purchases	545,000	
Salaries and wages	129,000	
Advertising	20,000	
Telephone and utilities	15,000	
Supplies and postage	6,000	
Insurance	11,000	
Property taxes	7,000	
Interest	<u>5,000</u>	
Total Cash Payments		(738,000)
Net Cash Flows from Operating Activities		<u>\$ 45,000</u>

EMERSON CORPORATION		
Statement of Cash Flows (Indirect Approach)		
For the Year Ending December 31, 20X5		
Cash flows from operating activities:		
Net income		\$1,000,000
Add (deduct) noncash effects on operating income		
Depreciation expense	\$ 120,000	
Gain on sale of land	(150,000)	
Increase in accounts receivable	(250,000)	
Decrease in inventory	40,000	
Increase in accounts payable	70,000	
Decrease in wages payable	<u>(30,000)</u>	<u>(200,000)</u>
Net cash provided by operating activities		\$ 800,000
Cash flows from investing activities:		
Sale of land	\$ 750,000	
Purchase of equipment	<u>(150,000)</u>	
Net cash provided by investing activities		600,000
Cash flows from financing activities:		
Proceeds from issuing stock	\$ 80,000	
Dividends on common	(50,000)	
Repayment of long-term loans	<u>(900,000)</u>	
Net cash provided by financing activities		<u>(870,000)</u>
Net increase in cash		\$530,000
Cash balance at January 1, 20X5		<u>170,000</u>
Cash balance at December 31, 20X5		<u>\$ 700,000</u>
Noncash investing/financing activities:		
Issued preferred stock for building		<u>\$ 300,000</u>
Supplemental information:		
Cash paid for interest		\$ 100,000
Cash paid for income taxes		300,000

and then works down to the ending cash balance. Sometimes, it needs additional balance sheet information f. ex. increase or decrease in accounts receivable, accounts payable or inventory that are given in the balance sheet. The statement of cash flows also gives something back to the balance sheet: verification. If the ending cash on the balance sheet doesn't match the ending cash on the statement of cash flows, there is a mistake somewhere that you need to correct Furthermore, the revision of IAS 1 in 2007 introduced a new statement -the statement of comprehensive income that can be presented in 2 statements: a separate Income Statement (or the P & L statement) and statement of other comprehensive income which might include:

- * Exchange differences on translating foreign operation¹,
- * Available-for-sale financial assets,
- * Cash flow hedges²,
- * Gains/Losses on Property revaluation,
- * Share of other comprehensive income of associates etc.

However the statement of profit and loss is by far the favorite and easy to understand among business owners; after all, this is the one that shows the profits. This statement can show you much more than the bottom line, though. It can let you know if you've been setting your prices too low, paying too much for the merchandise that you resell, or spending much too much on postage, customs etc. In addition to spelling out just how well your business has done over the past year (or month or quarter), it contains clues for improving profitability and beefing up that bottom line. First, though, you have to put it together. Three kinds of accounts appear on this financial statement: revenues, costs, and expenses. The statement is a kind of vertical equation that basically says "revenues minus costs minus expenses equals profit or loss."³ In the body of the report, revenues are listed right on top; costs (if you sell products) come next; and expenses are at the end. At the very bottom comes the bottom line, the company's

1 ACCA-F9- Financial Management Syllabus

2 ACCA-F9- Financial Management Syllabus

3 <http://www.netplaces.com/accounting/preparing-financial-statements/the-statement-of-profit-and-loss.htm>

overall net profit or loss for the period. Statements of profit and loss for service businesses are shorter than those for product-based businesses. Service companies don't need a section for cost of goods sold or gross profit, because they don't sell any goods. Other than that missing section, the statements look pretty much the same.

An analysis of expenses must be shown either in the income statement or by note by classifying them either by Nature of Expense or by their function. Function of Expense method can be also called as Cost of Sales method. Below we can see the following formats:

Income Statement by Nature of Expense:

		Gel
Sales Revenue		X
Other Incomes		X
Changes in Finished Goods and WIP	X	
Consumed materials	X	
Staff Costs	X	
Depreciation and Amortization Expenses	X	
Other Expenses	X	
Total Expenses		(X)
Profit		X

Income Statement by Function of Expense

Sales Revenue	X
Cost of Goods Sold	(X)
Gross Profit	X
Other Incomes	X
Commercial Expenses	(X)
Administrative Expenses	(X)
Other Expenses	(X)
Profit	X

In Summary, the differences exist between Cash flows and Income statements in profitability and actual real cash. **Some companies can ex-**

perience net income, and yet not possess sufficient cash to keep their businesses afloat. In the statement of Profit and Loss, profit is smoothed out through accruals, prepayments, provisions. Most companies use the accrual basis for recognizing revenue, which causes the cash account to lag behind net income. Transactions within the assets, liabilities and shareholders' equity accounts on the balance sheet also affect the cash account. In Business reality profit is not as important as the extent to which a company can convert its profit into real available cash on a continuing basis. However the statement of cash flows is strongly connected with the Income Statement as it takes important information from it; But differing from P & L statement, it focuses on actual cash. Thus both financial statements are interconnected and simultaneously differ in some categories, but each of them have it own independent right and importance for users during business decision-making process.