Cash flow analyses

Statement of Cash Flows in IFRS Financial Statements

18.5.2021

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Objectives of Statement of Cash Flows

"A Company which runs into heavy losses often makes a recovery. But if it runs out of cash (and credit) it will rarely get a second chance." (Holmes, Sudget & Gee: Interpreting Company Reports and Accounts)

"Cash flow is a fact. Net income is just an opinion" (Pablo Fernández)

Objectives of Statement of Cash Flows

- Companies need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.
  - The decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation.
- Statement of Cash Flows ("SCF") includes information about the historical changes in cash and cash equivalents that should enable users to:
  - evaluate changes in net assets of an entity
  - understand changes in financial structure (e.g. liquidity and solvency)
  - examine relationship between profitability and net cash flow
  - evaluate ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities
  - develop models to assess and compare the present value of the future cash flows of different entities (comparability!)
  - check accuracy of past assessments of future cash flows.

Temperature test

Which of the following is the objective of the cash flow statement?

(a) understand how the entity generates and uses cash

(b) evaluate the changes in net assets and financial structure

(c) enhance comparability of performance of different entities

(d) indicate the amount, timing and certainty of future cash flows

(e) all of the above

IAS 7 – Statement of Cash Flows

- **Scope – where is cash flow information disclosed**
- **Key requirement: reporting sources and uses of cash**

Scope – where is cash flow information disclosed?

IAS 1.10

A complete set of financial statements comprises:
(d) a statement of cash flows ; and
(e) notes, comprising a summary of significant accounting policies and other explanatory notes.

IAS 34.8

An interim financial report shall include, at a minimum, the following components:
(d) condensed cash flow statement;…(cumulative year to date)

IFRS 5.33

An entity shall disclose:
(c) the net cash flows attributable to the operating, investing and financing activities of discontinued operations.

⇒ In practice, every IFRS financial statement includes a SCF.
⇒ Discontinued operations separately disclosed to allow comparability/predictability.

Key requirement: reporting sources and uses of cash

IAS 7

IAS 7 includes guidance for Statement of Cash Flows: report cash flows during the period classified by operating, investing and financing activities.

Operating activities

- 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.

Investing activities

- Cash flows that are made to generate income and cash flows in the future (=investments) and cash flow from sale of investment assets.

Financing activities

- Cash flows related to equity and debt financing are useful in predicting claims on future cash flows by providers of capital.

Key requirement: reporting sources and uses of cash

How much cash flows do the business activities generate (sales)?

How much payments are necessary to maintain operating capability (interest, taxes, etc.)?

Operating activities
"Free Cash Flow"

Investing activities

How much investments are made to maintain or expand operating capacity?

Financing activities

How much cash is paid back to providers of capital? How are investments financed?

Key requirement: reporting sources and uses of cash

	Act 2019	Act 2020
Operating activities		
Cash receipts from customers	120 802	108 792
Cash paid to suppliers and employees	-105 323	-105 823
Interest received	206	230
Interest paid	-383	-197
Income taxes paid	-702	-758
Net cash from operating activities	14 601	2 244
Investing activities		
Purchase of PP&E	-834	-1 292
Proceeds from sale of equipment	43	50
Net cash used in investing activities	-790	-1 242
Financing activities		
Proceeds from long-term borrowings	0	0
Payment of long-term borrowings	-1 556	-1 453
Dividends paid	-1 743	-1 899
Net cash used in financing activities	-3 298	-3 353
Change in cash and cash equivalent	10 513	-2 352
Cash and cash equivalents 1.1.	1 100	11 613
Cash and cash equivalents 31.12.	11 613	9 261

Presentation of Statement of Cash Flows

- **Definition of cash and cash equivalents**
- **Classification of cash flows into operating, investing and financing activities**
- **Reconciliation of cash flows to balance sheet**
- **Disclosures**

Definition of cash equivalents

- *Short-term*

  - maturity period: 3 months or less from the date of acquisition

- *Readily convertible*

  - into a known amount of cash without an undue notice period

  - without incurring a significant penalty

- *Subject to an insignificant change in value*

- *Held for purpose of short term cash commitments* – purpose of holding

Cash subject to restriction may not qualify as cash

- held in a blocked account or escrow
- with specific purpose
- need bank's or customer/vendor etc. approval to withdraw

Definition of cash equivalents

Examples of financial instruments that can qualify as cash equivalents

- Bank deposits, government bonds, corporate bonds if meets the criteria (short term, readily convertible, insignificant risk of changes in value).
- Money market funds and mutual funds that invest in instruments that qualify as cash equivalents.

Examples of financial instruments that do not qualify as cash equivalents

- Investment in equity instruments and derivatives due to risk of changes in market value.
- Long term deposits with restrictions to convert to cash.
- Cash given as security and escrow accounts in some cases.

Definition of cash equivalents

What is the impact of the definition of cash and cash equivalents (CE)?

<u>Financial instrument in balance sheet:</u>

..share in listed company

..government bond

..bank deposit

<u>Cash flow in SCF:</u>

Operating activities		xx
Investing activities		xx
Financing activities	+	xx
Change in cash and CE		xx
Cash and CE 1.1.	+	xx
Cash and CE 31.12.		xx

Temperature test

	Cash equivalents?
1. A term deposit with a 3 month maturity	
2. A term deposit made on 1 Jan 20x1 – at the year end on 31 Dec 20x1, the remaining maturity is 2 months	
3. A deposit: • held in an escrow account requiring a third party's signature to withdraw	

Temperature test

Which criterion is **not** included in the definition of cash equivalents?

(a) readily convertible to known amount of cash

(b) short-term, highly liquid investments

(c) subject to an insignificant change in value

(d) investment in high-quality instruments

Classification of cash flows

Operating activities (A)		xx
Investing activities (B)		xx
Financing activities (C)	+	xx
Change in cash (A+B+C)	=	xx
Cash beginning of period	+	xx
Reconciling items	+	*xx*
Cash end of period		xx

Classification of cash flows

- *Key principle:* Depends on the nature of activity
- *Operating activities*

  - Principal revenue-producing activities of the entity

  - Other activities that are not investing or financing activities
- *Investing activities*

  -Acquisition and disposal of long-term assets and other investments not included in cash equivalents
- *Financing activities*

  -Activities that result in changes in the size and composition of contributed equity and borrowings

Temperature test

3. What is the principle in IAS 7 for the classification of cash flows?
   (a) Consistent with the classification of the related item in the balance sheet
   (b) According to the nature of the activity in a manner that is most appropriate to the business

Classification of cash flows

Operating activities

Cash flows from operating activities can be disclosed either using the direct or the indirect method. The direct method is recommended but indirect more popular in practice.

Direct method

- Separately discloses major classes of gross cash receipts and gross cash payments
- Includes information such as cash receipts from sales and cash payments for costs that is not apparent anywhere else in the financial statements
- Generally considered more challenging to prepare.

Indirect method

- Net profit or loss is adjusted for the effects of non-cash transactions, changes in working capital and items of income or expense associated with investing or financing cash flows
- Includes useful information about the relationship of net profit or loss to cash flows from operating activities.

Direct Cash Flow Statement

Cash flows from operating activities:	
Cash receipts from customers	0,00
Cash receipts from other operating income	0,00
Cash paid to suppliers and employees	– 0,00
Cash generated from operations	**0,00**
Interest paid	– 0,00
Interest received	0,00
Dividends received	0,00
Income taxes paid	– 0,00
Net cash from operating activities	**0,00**
Net cash used in investing activities	**0,00**
Net cash used in financing activities	**0,00**
Change in cash and cash equivalents	**0,00**
Cash and cash equivalents 1.1.	**0,00**
Cash and cash equivalents 31.12.	**0,00**

Indirect Cash Flow Statement

Cash flows from operating activities:	
Net profit (loss) before taxation	+/– 0,00
Adjustments for:	
Depreciation according to plan	0,00
Unrealised fx wins and losses	+/– 0,00
Other non-cash items	+/– 0,00
Financial income and expenses	+/– 0,00
Other adjustments	+/– 0,00
Operating profit before working capital changes	0,00
Working capital changes:	
Increase (–) or decrease (+) in trade and other receivables	0,00
Increase (–) or decrease (+) in inventories	0,00
Increase (+) or decrease (–) in trade payables	0,00
Cash generated from operations	**0,00**
Interest paid	– 0,00
Interest received	0,00
Dividends received	0,00
Income taxes paid	– 0,00
Net cash from operating activities	**0,00**
Net cash used in investing activities	**0,00**
Net cash used in financing activities	**0,00**
Change in cash and cash equivalents	**0,00**
Cash and cash equivalents 1.1.	**0,00**
Cash and cash equivalents 31.12.	**0,00**

Classification of cash flows

Operating activities – financial items and taxes

Cash flows from interest and dividends received and paid and taxes paid should each be disclosed separately. These items are classified in a consistent manner from period to period as either operating, investing or financing activities:

- **Interest paid** are usually classified as operating cash flows as they enter into the determination of net profit or loss. Alternatively**,** interest paid may be classified as financing cash flows because they are costs of obtaining financial resources.
- **Interest and dividends received** are usually classified as operating cash flows. Alternatively, interest and dividends received can be classified as investing cash flows because they are on investments.
- **Dividends paid** are usually classified as a financing cash flow because they are a cost of obtaining financial resources. Alternative method is to classify as operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows.
- **Income taxes** paid are classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Classification of cash flows
Investing activities

<u>Cash Flow Statement</u>

Net cash from operating activities	**0,00**
Cash flows from investing activities:	
Purchase of tangible and intangible assets	– 0,00
Proceeds from sale of tangible and intangible assets	0,00
Purchase of investments	– 0,00
Proceeds from sale of investments	0,00
Loans granted	– 0,00
Proceeds from repayments of loans	0,00
Interest received	0,00
Dividends received	0,00
Net cash used in investing activities	**0,00**
Net cash used in financing activities	**0,00**
Change in cash and cash equivalents	**0,00**
Cash and cash equivalents 1.1.	**0,00**
Cash and cash equivalents 31.12.	**0,00**

Companies should report <u>gross</u> cash receipts and <u>gross</u> cash payments arising from investing activities. This information is usually derived by analysing changes in balance sheet accounts.

Classification of cash flows

Determining cash flows from investing activities - example

	Cash		Accounts payable		Equiment		Income statement	
Opening balance	500			100	1000			
Cash dispurement		100	100					
Purchase of assets				500	500			
Cash dispurement		500	500					
Purchase of assets				200	200			
Sale of assets	400					300		100
Acquired subsidiary					600			
Depreciation						250	250	
	900	600	600	800	2300	550	250	100
Closing balance			200			1750		

Purchase of tangible assets	
Closing balance	-1750
Opening balance	1000
Depreciation	-250
Acquisition cost of sold equipment	-300
Acquired subsidiary's equipment	600
Payables opening balance	-100
Payables closing balance	200
Payments to purchase assets	-600

Proceeds from sale of tangible assets	
Gain on sale	100
Acquisition cost of sold equipment	300
Proceeds from sale:	400
(+/- sales price receivables)	

Classification of cash flows

Financing activities

Cash Flow Statement

Net cash from operating activities	**0,00**
Net cash used in investing activities	**0,00**
Cash flows from financing activities:	
Proceeds from issuance of share capital	0,00
Purchase of own shares	– 0,00
Proceeds from sale of own shares	0,00
Proceeds from short-term borrowings	0,00
Repayment of short-term borrowings	– 0,00
Proceeds from long-term borrowings	0,00
Repayment of long-term borrowings	– 0,00
Dividends paid	– 0,00
Net cash used in financing activities	**0,00**
Change in cash and cash equivalents	**0,00**
Cash and cash equivalents 1.1.	**0,00**
Cash and cash equivalents 31.12.	**0,00**

Short-term borrowings, for example, those which have a maturity period of three months or less, can be reported on net basis => "change in short-term borrowings".

Reconciliation of cash flows to balance sheet

- The net change of cash and cash equivalents is the sum of net cash flows from operating, investing and financing cash flows. This may differ from the balance sheet due to
  - different definition of cash and cash equivalents,
  - effect of foreign exchange rate changes to cash and cash equivalents and
  - certain acquisitions or disposals of businesses.
- Companies should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

…	
Change in cash and cash equivalents	+/- xx
Effect of foreign exchange rates on cash and cash equivalents	xx
Cash and cash equivalents 1.1.	xx
Cash and cash equivalents 31.12.	xx

Non-Cash transactions

- Many investing and financing activities do not involve cash flows although they do affect the capital and asset structure of an enterprise (i.e. the balance sheet), e.g.
  (a) the acquisition of assets either by assuming directly related liabilities or by means of a finance lease
  (b) the acquisition of an enterprise by means of an equity issue
  (c) the conversion of debt to equity.
- Transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement and be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Temperature test

Which of the following is a non-cash transaction?

(a) Acquisition of assets by means of liability or finance lease

(b) Acquisition of an entity by means of an equity issue

(c) Conversion of debt to equity

(d) All of the above

Disclosures

- IAS 7-standard includes disclosure requirements for the Statement of Cash Flows. These are normally reported as footnotes but can also be disclosed in the face of the SCF.
- The most significant disclosure requirements are:
  - Explaining the components of cash and cash equivalents and reconcile their change in cash flow statement to the balance sheet.
  - Disclosing the amount of significant cash and cash equivalent balances that are not available for use by the group.
  - Explaining the cash flow impact of acquisition/disposal of businesses.
- Recommended but not required disclosures include:
  - Undrawn borrowing facilities.
  - Investing cash flows separately for the purpose of increasing operating capacity and for maintaining operating capacity.
  - Segment reporting of cash flows.

Disclosures

- Requirement to give a "Reconciliation of net debt":
  - Basically a reconciliation of financing cash flows to the changes in debt balances.
  - Transparent information about movements in borrowings to help users of financial statements evaluate the financial health of an entity.

	At 1 January 20x7	Cash flows	Non-cash changes					At 31 December 20x7
			Acquisition	Interest accretion	Foreign exchange movement	New leases	Fair value change	
	'000	'000	'000	'000	'000	'000	'000	'000
(1) Short-term bank borrowings	10,000	(300)	-	-	-	-	-	9,700
Long-term bank borrowings	22,000	500	3,000	-	3,000	-	-	28,500
Other long-term borrowings	1,000	(400)	-	-	-	-	-	600
Finance lease liabilities	3,000	(250)	-	200	-	500	-	3,450
Interest payable	456	(2,100)	-	2,500	-	-	-	856
Assets held to hedge long-term borrowings	(300)	150	-	-	-	-	(40)	(190)
	36,156	(2,400)	3,000	2,700	3,000	500	(40)	42,916
(2) Cash and cash equivalents (other than bank overdraft)	(30,000)	300	-	-	250	-	-	(29,450)
(2)(3) Bank overdraft	2,100	(200)	-	-	-	-	-	1,900
Cash and cash equivalents	(27,900)	100	-	-	250	-	-	(27,550)
	8,256	(2,300)	3,000	2,700	3,250	500	(40)	15,366

Impact of IFRS 16

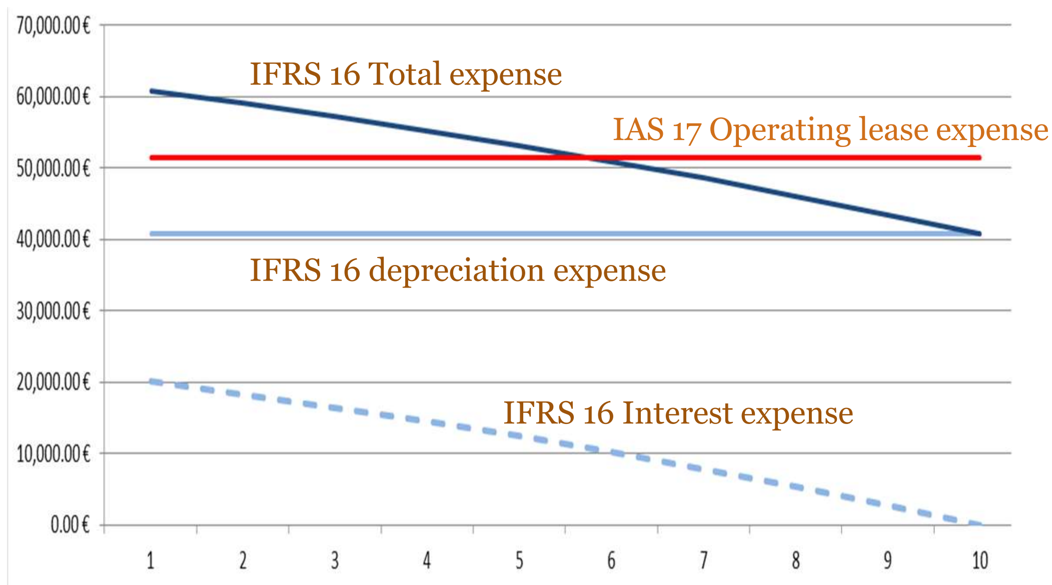
IFRS 16: leases on the balance sheet

All leases

- Right-of-use asset
- Lease liability

- Depreciation expense
- Interest expense

Pattern of expense recognition in profit or loss



Impact of IFRS 16

Statement of cash flows

Cash flows from operating activities

Short-term lease payments

Payments for leases of low value assets

Variable lease payments not included in lease liability

Cash payments for the interest portion of the liability

Depending on entities' policy for interest payments

Cash flows from financing activities

Cash payments for the principal portion of the liability

Cash payments for the interest portion of the liability

Impact of IFRS 16

What needs to be considered in financial statement analysis?

- Increased assets and liabilities impact balance sheet derived KPIs such as (equity ration, ROCE, etc.)
- EBITDA and Operating cash flows impacted significantly although impact to EBIT and Result was normally minor and impact to total cash flows was zero.

Balance sheet	Income statement	Cash flow statement
↑ Lease assets	↓ Operating expenses	↓ Operating cash outflows
↑ Financial liabilities	↑ Finance costs	↑ Financing cash outflows

Effect on reported information, but no effect on a lessee’s economic position or commitments to pay cash

Check out blog on the impact to valuation analysis of companies:
https://uutishuone.pwc.fi/kassavirtalaskelmat-ja-ifrs-16/

Consolidated Statement of Cash Flows - key challenges:

- **Sale of subsidiary or a business**
- **Acquisition of a subsidiary or a business**

Consolidated Statement of Cash Flows

Business disposals

The aggregate cash flows arising from acquisitions and disposals of subsidiaries or other business units should be presented separately <u>as a single line item in investing activities</u>.

- <u>Acquisition</u>: The amount of the cash paid as purchase consideration net of cash and cash equivalents acquired (e.g. subsidiary's bank accounts at acquisition date).
- <u>Disposal</u>: The amount of the cash received as sales price net of cash and cash equivalents disposed (e.g. subsidiary's bank accounts at disposal date).
- <u>The challenge</u>: The transaction has either increased or decreased the assets and liabilities in the consolidated balance sheet. These increases and decreases need to be eliminated when calculating the consolidated statement of cash flows based on the changes in consolidated balance sheet accounts.

Consolidated Statement of Cash Flows
Acquisition of a subsidiary – simplified example

The Group acquired 100 % of the shares in subsidiary X for 590 €.

Purchase price calculation:	
Cash and cash equivalents	40
Inventory	100
Trade receivables	100
Property, plant and equipment	600
Group goodwill	50
Short-term borrowings	-100
Long-term borrowings	- 200
Purchase price	590

Acquired assets and liabilities including goodwill are eliminated from the group balance sheet before calculating cash flows on basis of changes in balance sheet accounts.

Cash flow statement:	
Purchase price	- 590
+ Cash and cash equivalents received	40
Cash flow on investment in subsidiary	- 550

Aggregate cash flow impact of the acquisition is disclosed as a separate line item in the SCF.

Consolidated Statement of Cash Flows

Disposal of 70 % owned subsidiary for 150 € – example

Subsidiary's balance sheet at disposal date		
Assets		
Intangibles		10
Tangibles		30
Investments		10
Receivables		50
Cash and cash equivalents		30
		130
Liabilities and equity		
Equity		80
Long term borrowings		30
Short term borrowings		20
		130
Gain on sale		
Sales price		150
Subsidiary's equity	80	
of which group owns 70 %	56	-56
Write-down of group goodwill		-60
Gain on sale		34

Impact to consolidated balance sheet	
cr intangibles	10
cr tangibles	30
cr investments	10
cr receivables	50
cr cash and cash equivalents	30
cr group goodwill	60
cr gain on sale	34
	224
db non-controlling interest	24
db long term borrowings	30
db short term borrowings	20
db cash and cash equivalents	150
	224
Cash flow from sale of subsidiary	
Sales price	150
Subsidiary's cash and cash equivalents	-30
Aggregate cash flow impact	120

Consolidated Statement of Cash Flows

Disposal of 70 % owned subsidiary for 150 € – example

Impact to consolidated balance sheet	**Group before sale**	**Impact of sale**	**Group after sale**
Intangible assets	40	-10	30
Group goodwill	100	-60	40
Tangible assets	140	-30	110
Investments	10	-10	0
Receivables	120	-50	70
Cash and cash equivalents	130	120	250
	540	-40	500
Equity	196		196
Gain on sale		34	34
Non-controlling interest	24	-24	0
Long term borrowings	180	-30	150
Short term borrowings	140	-20	120
	540	-40	500

Consolidated Statement of Cash Flows

Disposal of 70 % owned subsidiary for 150 € – example

Step 1.
Eliminate impact of sale of subsidiary to group balance sheet as of 31.12. and replace with the cash flow from sale of subsidiary:

Sales price	150
”Sold cash and CE”	-30
Cash flow from sale	120

Step 2.
Calculate change in group balance sheet line items after impact of sale of subsidiary (in this example this is the only cash flow during the period).

Step 3. Move the last column to the group cash flow statement:

BALANCE SHEET	31.12.	1.1.	Change	Elimination	Change
Intangible assets	-30	40	10	-10	0
Group goodwill	-40	100	60	-60	0
Tangible assets	-110	140	30	-30	0
Investments	0	10	10	-10	0
Receivables	-70	120	50	-50	0
Cash and CE	-250	130	-120		-120
Equity	196	-196	0	0	0
Gain on sale (ret.earnings)	34	0	34	-34	0
Non-controlling interest		-24	-24	24	0
Long term borrowings	150	-180	-30	30	0
Shor term borrowings	120	-140	-20	20	0
CASH FLOW STATEMENT					
Cash flow from sale of subsidiary				120	120
Check:	**0**	**0**	**0**	**0**	**0**

Change in cash and cash equivalents

Investing cash flows

Challenges and common pitfalls in Cash Flow Statement preparation

Challenges and common pitfalls
One of the most frequently restated item

- Percentage of restatements in 2014 due to statement of cash flows (statistic from US listed companies).

20%

Challenges and common pitfalls

Common restatements and misstatements

- Inappropriate classification of cash transactions between operating, investing and financing activities
- Inappropriate consideration of non-cash investing and financing activities
- Failure to appropriately consider the impact of significant, unusual and nonrecurring transactions on the statement of cash flows
- Classification of receivables and payables related to investment activities, financial items or taxes to working capital.
  - E.g. PP&E additions purchased or received at period end, but not yet paid for, are reported as a cash flow.
- Classification of interest and dividends received (e.g. dividends from associate companies).

Challenges and common pitfalls

Restatement of previously issued financial statements

"Management discovered that the capital expenditures on… [the Company's] Consolidated Statements of Cash Flows *did not correctly account for the beginning of period unpaid invoices and accruals (that were paid in cash during the period)* and is restating its previously filed Consolidated Statements of Cash Flows… to correct for such misstatement by adjusting cash used for "Capital expenditures" (investing activity) and change in accounts payable (operating activity)."

Challenges and common pitfalls

Restatement of previously issued financial statements

"…the correction of an error related to the presentation of contingent consideration in purchase accounting…"

"…excess cash from discontinued operations had been misclassified by reporting it as an operating activity rather than an investing activity…"

"The affected financial statements reflected… cash inflow from the sale of an asset group held for sale within the changes in operating assets and liabilities section of our Consolidated Statement of Cash Flows. The cash inflow should have been presented within the investing section…"

Challenges and common pitfalls

Restatement of previously issued financial statements

"…error occurred in the cash flow classification of certain transaction with an owner… originally reported as a reduction of cash flows from operating activities but should have been presented as a reduction of cash flows from investing activities…"

"…a working capital settlement paid to Seller was presented in operating activities and should have been presented in investing activities…"

"…advances to equity affiliate were improperly classified as an operating activity rather than an investing activity…"

Challenges and common pitfalls

Regulator and financial analyst comments

Too much diversity in items classified as cash equivalents

Different starting point to determine operating cash flows

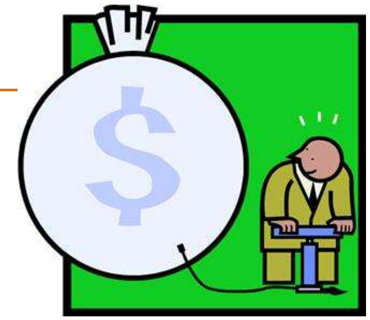
Inconsistent classification of cash flows

Netting items in cash flow statements

Material or unusual items not disclosed separately

Inconsistency between the cash flow statement and elsewhere in the report

Challenges and common pitfalls
Manipulation of cash flows



- An intentional manipulation generally involves:
  - Incentive or pressure: e.g. monetary such as making targets or non-monetary such as reputation.
  - Opportunity: lack of review and control.
  - Rationalization or justification.
- Examples in practice:
  - Inappropriate classification of cash flows to operating, investing, financing (normally to inflate cash flow from operations).
  - "Double accounting" the same transaction to inflate operations.
  - Delaying cash disbursements at the end of period or agreeing (costly) advance payments.
  - Treatment of factoring and similar transactions.

Any questions?

The matters raised in this and other reports that will flow from the audit are only those which have come to our attention arising from, or relevant to, our audit that we believe need to be brought to your attention. They are not a comprehensive record of all the matters arising, and in particular we cannot be held responsible for reporting all risks in your business or all internal control weaknesses. This report has been prepared solely for your use and should not be quoted in whole or in part without our prior written consent. No responsibility to any third party is accepted as the report has not been prepared for, and is not intended for, any other purpose.