Preparing cash flow statements

An interesting feature of New Zealand's new financial reporting requirements is the requirement to prepare a statement of cash flows. Hence any general purpose financial statements required by law now need to include one of these statements. This requirement relates to both the "For-Profit" sector as well as for Public Benefit Entities.

The construction of a cash flow statement is a new concept for many New Zealand accountants because it has previously not been a 'main' statement requirement for most entities. The required cash flow statement is also relatively young (compared to double-entry accounting which is 500 years old ☺) and it perhaps hasn't previously received the emphasis it deserves as one of the three primary financial statements. However, this is perhaps surprising when you consider that the generation of cash is the lifeblood of most organisations.

What is a cash flow statement?

An entity's statement of cash flows essentially creates a reconciliation between its cash balances from one accounting period to the next. As the name implies, it shows the cash that has flowed through the entity.

Cash flow statements enable users to develop models to assess and compare the present value of the future cash flows of different entities. They summarise and provide information on how the income statement and balance sheet translates to cash.

Cash flow statements also enhance the comparability of the reporting of operating performance by different entities because they eliminate the effects of using different accounting treatments for the same transactions and events.

In a nutshell, a cash flow statement is an aid to translating the income statement and balance sheet from documents based on what can sometimes seem like an arcane financial framework to an easily understood summary of cash generated and spent.

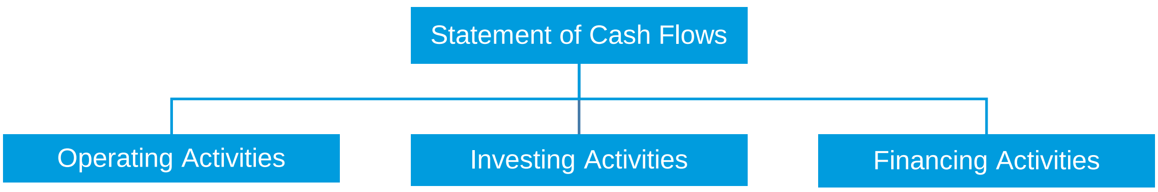
How can it help me?

Revenue is an important component of any entity's financial health. However, revenue is only useful once it is collected. The importance of cash flow and the distinction between revenue and cash flow is perhaps best summed up in the following saying; *Revenue is like food and cash is like oxygen. You can go for a while without food, but you can't go for very long without oxygen!*

By being able to analyse a cash flow statement, users should be able to make better informed decisions as they will have a more comprehensive view of the economic health of an entity.

A cash flow statement is classified into three categories:

1. Cash flows from operating activities
2. Cash flow from investing activities
3. Cash flows from financing activities



How to analyse these classifications

Operating Activities

A healthy entity normally generates sufficient cash from its core operating activities. Using the cash generated from the core operating activities, and depending on whether the cash inflow is sufficient enough, the entity may then invest those surplus funds either to maintain or enhance their operating capacity, repay loans, pay dividends (for a For-Profit entity) and make new investments without recourse to external sources of financing. All these are signs of an entity in good financial health.

You want to see positive cash flow when analysing cash generated from operations because the operating activities are normally the primary source of cash for an entity. If an entity has negative cash flow from operating activities, it is generally a cause for concern.

Where an entity consistently reports growth on its income statement, but has negative cash flow, it is a sign of inefficiently translating that growth into cash. Such entities are more likely to face liquidity problems which could lead to defaulting on their current liabilities. Entities that consistently report operating cash flow that is greater than their net income may be gaining momentum.

Investing Activities

The cash flows from investing activities represent the extent and ability to which past expenditures have been made for resources intended to generate future income and cash flows.

If an entity generates enough cash to invest continually in property, plant and equipment as well as other fixed assets, it is an indication that the entity aims to replace technologically obsolete equipment to keep up with the latest trends, in essence, "investing" in its future sustainability.

A healthy entity will generally re-invest its surplus cash at least at the rate of the annual depreciation expense in order to maintain the efficiency of its operating activities. If it is not doing so, it might report cash inflows from investing activities but these are unlikely to be sustainable in the long run.

Financing Activities

Cash flows from financing activities are important because they are useful in predicting claims on future cash flows by providers of capital to the entity.

The cash flows from financing activities should be carefully evaluated when interpreting cash flow statements. Investors should compare current debt financing with past periods to determine if the entity has increased or reduced its costs related to servicing any debt over time.

Except where large or unusual activities are being undertaken, such as construction of significant long term assets, a healthy entity should be generating enough cash from operating activities in order to finance its investing activities without the use of outside financing.

Remember, when analysing an entity, it is vitally important to perform comparative analyses over more than one accounting period as that is the only way one can identify trends.

Conclusion

We are excited that the cash flow statement will be given the spotlight it deserves as a vital part of financial reporting. This is a welcome addition as not only does it allow potential investors and other stakeholders to make more informed decisions, it also allows entities themselves to see a holistic picture of their organisation and an out-of-the-bubble view of their objectives and whether they are being met. We also suggest including a cash flow statement as a regular reporting item in a board pack or management accounts.

History is littered with seemingly profitable entities that go broke. Hence we close with another pertinent saying that "Cash is king!".

About the Authors

Brendon Foy is an Audit Manager at RSM with experience across a wide range of entities in both for profit and public benefit entities in New Zealand. Brendon is based in the RSM Newmarket office.

Contact Brendon on:
D: +64 (9) 367 1657
E: brendon.foy@rsmnz.co.nz
W: www.rsmnz.co.nz

Alexa Bayes originally qualified in South Africa and has recently moved to New Zealand. She is a senior in the technical team of RSM currently based in the RSM Manukau office.

Contact Alexa on:
D: +64 (9) 367 1656
E: alexa.bayes@rsmnz.co.nz
W: www.rsmnz.co.nz