Cash flow statement: meaning and practical use (2/44/19)

The cash flow statement (CFS) is a statutory financial statement to be prepared in Latvia by only medium and large companies (sizes defined by the Company and Consolidated Accounts Act). There are not many companies of this size against the total number of companies in Latvia, and even the ones covered by this requirement often approach the CFS as a formal requirement that gives no benefit to their management. Is that true? Not quite, and let's explore why.

What is the cash flow statement?

To talk about the CFS, we should first understand what cash really means. Cash is not only the physical banknotes in our wallets, it is also the cash in our bank account as well as any deposits for a relatively short term that can be used quickly. Any cash other than cash in hand and cash at bank is referred to by finance professionals as cash equivalents.

Cash = Cash + Cash Equivalents

The CFS is a key financial statement that shows the cash and cash equivalents actually received and paid during the financial period as well as the cash balance at the end of the period.

The purpose of the CFS is to show the financial position in terms of cash received and paid by deviating from the accounting principle of accruals and showing how much disposable cash the business has, who the cash was received from during the year, and what purposes it was used for.

While the CFS is mainly used by accountants and finance directors, it should also be used by shareholders, lenders, prospective lenders, prospective investors, prospective employees, and prospective suppliers.

Why prepare the CFS?

The CFS is designed to show how commercial transactions affect the cash balance. Like the income statement (IS), the CFS shows changes that took place over a particular period. Any discrepancies between the IS and the CFS can have the following causes:

- Timing differences (e.g. an invoice booked for electricity consumed in December 2018 will not be paid until January 2019);
- Changes in fair value (e.g. a company's revaluation of its investment properties has resulted in no extra cash flow, only revenue);
- Other non-cash items (e.g. a company has made a provision for a potential penalty not payable until next year).

The main thing is that unlike the IS and the balance sheet (BS), which are allowed to contain accounting estimates and assumptions that may result in similar businesses having different indicators, the CFS clearly shows the cash actually received and paid.

Where required by law, the CFS must be prepared annually, yet financial theory recommends that large companies prepare it at least monthly and small companies or self-employed persons quarterly.

The CFS is not only financial data but also an analytic tool for –

- monitoring an entity's short-term viability and liquidity, i.e. its ability to pay creditors;
- providing additional information by measuring changes to an entity's assets, liabilities and shareholders' equity, as well as their sources;
- making it easier to compare businesses after excluding the effect of different accounting policies.

Cash flows are used in investment valuation methods, such as the net present value (the sum of discounted future cash flows), so the CFS allows prospective investors to evaluate business opportunities more accurately. As part of an entity's annual report, the CFS looks back at past movements in cash and cash equivalents. In measuring an entity's value, however, the CFS represents a forecast of future movements in cash and cash equivalents.

Methods for preparing the CFS and selection principles

There are two alternative methods (one should be used consistently):

- The indirect method aligns pre-tax profits with cash flows from operating activities;
- The direct method shows gross cash flows, i.e. the cash actually received and paid.

	Direct method	Indirect method
Pros	• The Association of International Accountants recommends it as best practice; • Easier to understand for a reader without prior knowledge; • Provides details of cash actually received and cash actually paid.	• More often used in practice, so it provides better comparability between businesses; • Easier to prepare and check (directly derived from the IS and the BS);
Cons	• A separate record should be kept for access to information; • More difficult to prepare and check; • Less often prepared in practice.	• More difficult to understand for a reader without prior knowledge; • Cash received and cash paid is not directly seen.

Elements of the CFS

The CFS offers the following distribution of cash flows according to the main lines of business:

- Operating activities;
- Investing activities;
- Financing activities.

(to be continued)