

The Impact of Cash Flow Ratio on Coparate Performance

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Abstract

Performance appraisal based on accrued financial statement which had led to poor decision making resulting to corporate failure and rendering of investors helpless had led to the need for this study. In view of the above, this study ascertains the applications of cash flow ratio as a better tool for assessing corporate performance. In this study, performances were measured using liquidity ratio and asset management ratio. In carrying out this study, liquidity ratios and asset management ratios of organization were computed based on accrued and cash basis accounting. Results obtained showed that liquidity ratios computed on accrued basis showed good liquidity that company will be able to meet its financial obligation very well and effective asset management; while liquidity ratios computed on cash basis showed negative liquidity position/inefficient asset management which means the organization studied may not be able to meet up its financial obligation. Thus, this may lead to corporate failure, if proper course of action is not taken by management. The implication of the above results showed that accrued financial ratios maybe misleading in making investment decision and appraising performances, thus the cash basis ratio maybe preferred as a better tool for assessing corporate performance since this gives a better insight on viability and liquidity position of the coporate organization and serves as a good tool for predicting corporate failure.

Keywords: cash flow ratio, Corporate performance, accrued ratios, CFFO

1. Introduction

The objective of accounting information is to provide adequate and relevant information which will be useful both to internal users and external users in making useful decisions as concerns corporate entity operations and performances. (Soyade, 2007)

Smith, Keith and Stephens(1993), in line with the above states that all of us make economic decisions throughout our lives as members of families, of group and of our society as a whole, or employees and even as club members we face economic decisions constantly. Accounting information provides the fact needed to make informed economic decisions. This information is typically provided in the form of financial reports.

According to CAMA (1990), financial information required to be shown in the annual corporate financial reports includes, statements of accounting policies, balance sheet, profit and loss account, notes on the accounts, the auditor's report, the directors report, a value added statement for the year, a five year financial summary, and in the case of a holding company, the group financial statements and Source and Application of fund i.e. fund flow statement which is being replaced with the cash flow statement (SAS 18).

However, of all the accounting information reports being required to be published; only cash flow statement is prepared on cash basis. Cash flow statement according to Okwuosa(2009), is a financial information which shows cash inflows and outflow of an enterprise in a given accounting year or a reporting period, but excludes inflows arising from changes in cash as a result of purchase and liquidation of cash equivalent.

From the above, it could be said that cash flow statement is an accounting report which is prepared to help users to know how cash and cash equivalent has been generated and utilized and the changes in the cash balance by entity in a given accounting period.

According to SAS 18 the main reason statement of cash flow is now regarded as preferred parameter for evaluating corporate liquidity is that the statement of source and application of funds based on movement in working capital can obscure movements relevant to assessing the viability and liquidity of an enterprise. It is the above deficiency that had led to the introduction of cash flow statement.

Since, the cash flow statement is seen as better financial information for assessing corporate viability and liquidity, thus, cash flow statement can also be subjected (applied as a better tool for assessing (computing); performance ratios for making good investment decision and preventing corporate failure. In view of the above, this study considers the impact of cash flow statement as a tool for evaluating corporate performance.

2. Statement of the Problem

The use of accrual financial statement for analyzing and measuring corporate performance by management and other users have been found to have inherent problems and limitation which may have resulted to poor decision making, inefficient management and sometimes corporate collapse.(Blum,1974, Aziz et al,1988, Casey and Bartzak,1985). Enyi, (2006) states that the rate at which businesses sprang up and went under is still of much

concern to average discerning entrepreneurs, worst hit in this wave of financial misfortune are banks and their helpless customers. The CIC economic report (2005) states that “The fallout of the liquidation exercises caused widespread hardships to the banking public, which equally led to collapse and liquidation of many non banking organizations and bankruptcy of individuals as result of the negative multiplier effect. The inherent problems and limitations which are associated with accrued basis accounting ratio are listed below;

3. Limitations of Financial Ratios

- (a) Financial ratios only trigger off points for further investigation.
- (b) Ratios cannot be used to compare results of two or more companies except where they have similar accounting policies.
- (c) Financial analysis based on accounting ratios may give misleading results if effects of the changes in price level are not taken into accounts.
- (d) Financial ratios are generally calculated from past financial statements and these are no good indicators of the future.
- (e) Ratios calculated at a point in time are less informative and defective as they suffer from short term changes.
- (f) No fixed standard can be laid down for an ideal ratio.

4. Problems of Financial Statements

- (a) Applications of accounting concept and convention may not be the same from company to company.
- (b) Financial statement are prepared to show true and fair view, hence the actual figures may not be shown in the financial statement.
- (c) Financial statement only discloses monetary facts. Non monetary fact can only be disclosed in notes to the financial statement.

5. Objectives of the Study

To ascertain whether cash flow statement can serve as a better tool for measurement of corporate performance than accrual financial statement

To find out whether cash flow ratio can be more useful in predicting liquidity and viability of the companies, than accrual financial ratios

To determine whether cash flow ratio can serve as a better indicators for assessing corporate failure than traditional (Historical) ratio.

To find out the sets of ratios that can be calculated (derived) from cash flow statement.

6. Hypotheses

Ho1 There is no relationship between ratios prepared on cash flow statement and that prepared on accrual financial statement.

Ho2 Cash flow ratios are not better tool for predicting corporate failure

Ho3 Ratios prepared from cash flows statements may not be useful in predicting liquidity and viability of the companies.

7. Definition of Cash flow/Cash

In financial accounting, a cash flow statement, also known as *statement of cash flows*, is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents, and breaks the analysis down to operating, investing, and financing activities (Helfert, 2001). The statement of cash flows details all cash inflows and outflows and boils it down to how much cash the company has generated in a given period. The cash flow statements is usually calculated based on cash basis and this tries to show better indication of corporate performance in respect to liquidity. Cash is king and is the blood of a business, It has to flow evenly (Jenn,2003). Jean 2003 went further to state that holding plenty of cash is never a bad thing but there is exception to this as well. On the other hand, too much outflow is equivalent to getting shot and seeing blood pour out from hole.

From the above it could be said that cash is essential and of great importance for corporate survival. For a company to be healthy the cash from operation should be positive and enough to meet up daily obligation of the business.

8. Impacts of Cash flow Statement

Holfstrand,(2009) states that cash is the ingredient that makes the business operate smoothly just as grease is the ingredient that makes a machine function smoothly .This means cash can be seen as the life wire of any

business and without cash business activities will not be effectively and efficiently managed.

The cash flow statement is expected to provide information which will help assess corporate liquidity, solvency and viability(Casey And Bantezak 1985)

It provides relevant information which will assist users in evaluating changes in assets liability and equities.

Easy comparison of corporate performance of different organization eliminating the effect of different accounting methods.

A good indicator of the amount, timing and probability of future cash flows

The above benefits/ aim are in line with Epstein and Eva (2007) of cash flow statement which states that cash flow statement is intended to

- provide information on a firm's liquidity and solvency and its ability to change cash flows in future circumstances
- provide additional information for evaluating changes in assets, liabilities and equity
- improve the comparability of different firms' operating performance by eliminating the effects of different accounting methods
- indicate the amount, timing and probability of future cash flows

9. Difference Between Cash flow Ratio and Accrual Financial Ratio

Accrual financial ratio is prepared based on historical cost while cash flow ratio is prepared based on cash. From the above, it could be said that since cash flow ratio are prepared from cash flow statement this give better indication of corporate performance than accrual accounting which uses past events to foresee future events. From this statement it could be said that corporate performance may be in financial distress while profitability is been disclosed without been in existence if historical (accrued) cost accounting is being adopted in appraising performance. Thus, since cash flow ratio is prepared on cash basis this gives a better indication of corporate performance. Lee (1982) a strong advocate of cash flow basis, revealed in his analysis of CFFO, that laker airway was in financial trouble three years prior to failure while profits were increasing as failure approached. Cash flow ratio will provide better information for predicting bankruptcy and liquidation. Information obtain from cash flow will be more relevant in predicting corporate failure and bankruptcy since the cash flow ratio is prepared on reported cash flow from operations. Beaver (1966) reported that CFFO provided by net income plus depreciation, depletion and amortization to total debt, had the lowest misclassification error relating to common accrual measures of financial health.

10. Difference Between Cash flow and Profitability

Cash flow and profitability although closely related are different. The differences between cash flow statement and profitability are below.

TABLE 1

Difference Between Cash flow and Profitability.

CASH FLOW	PROFITABILITY
Inflows and Outflows; the items recorded are inflows and outflows of cash	Measures incomes and expenditure; This records the income and expenditure
Shows liquidity; this shows liquidity position of an operation and ability of the firm to offset its liability	This shows profitability
Prepared on cash basis(considers present and future cost)	Prepared on historical cost(considers past cost)

11. History of Cash flow Statement

The cash flow statement is an old concept. The source and application of fund known as fund flow statement inexistence for decades and have been replaced by cash flow statement because of its inherent problem has continued to be existence since 18th century. Helfferth (1972) states that in 1863, the Dowlais Iron Company had recovered from a business slump, but had no cash to invest for a new blast furnace, despite having made a profit. To explain why there were no funds to invest, the manager made a new financial statement that was called a comparison balance sheet, which showed that the company was holding too much inventory. This new financial statement was the genesis of Cash Flow Statement that is used today (Watanabe 2007). In the United States in 1971, the Financial Accounting Standards Board (FASB) defined rules that made it mandatory under Generally Accepted Accounting Principles (US GAAP) to report sources and uses of funds, but the definition of "funds" was not clear. Net working capital might be cash or might be the difference between current assets and current liabilities. From the late 1970 to the mid-1980s, the FASB discussed the usefulness of predicting future cash flows (Epstein and Eva, 2007). In 1987, FASB Statement No. 95 (FAS 95) mandated that firms provide cash flow statements (Bodie et al 2004). In 1992, the International Accounting Standards Board issued International

Accounting Standard 7 (IAS 7), *Cash Flow Statement*, which became effective in 1994, mandating that firms provide cash flow statements (Epstein and Eva, 2007).

US GAAP and IAS(7) rules for cash flow statements are similar, but some of the differences are:

- IAS 7 requires that the cash flow statement include changes in both cash and cash equivalents. US GAAP permits using cash alone or cash and cash equivalents.
- IAS 7 permits bank borrowings (overdraft) in certain countries to be included in cash equivalents rather than being considered a part of financing activities.
- IAS 7 allows interest paid to be included in operating activities or financing activities. US GAAP requires that interest paid be included in operating activities.
- US GAAP (FAS 95) requires that when the direct method is used to present the operating activities of the cash flow statement, a supplemental schedule must also present a cash flow statement using the indirect method. The IASC strongly recommends the direct method but allows either method. The IASC considers the indirect method less clear to users of financial statements. Cash flow statements are most commonly prepared using the indirect method, which is not especially useful in projecting future cash flows.

12. Make Up Of Accrual Basis Of Accounting And Cash Flow Basis Of Accounting

This is made up of the balance sheet and profit and loss statement. The balance sheet is a snapshot of a firm's financial resources and obligations at a single point in time, and the income statement summarizes a firm's financial transactions over an interval of time. These two financial statements reflect the accrual basis accounting used by firms to match revenues with the expenses associated with generating those revenues. The cash flow statement includes only inflows and outflows of cash and cash equivalents; it excludes transactions that do not directly affect cash receipts and payments. These non-cash transactions include depreciation or write-offs on bad debts or credit losses to name a few (Epstein and Eva 2007). The cash flow statement is a cash basis report on three types of financial activities: operating activities, investing activities, and financing activities. Non-cash activities are usually reported in footnotes.

Make up of cash flow statement

The cash flow statement is partitioned into three segments, namely:

1) Cash flow resulting from operating activities	X
2) Cash flow resulting from investing activities	X
3) Cash flow resulting from financing activities.	X
Net Cash flow	XX

The money coming into the business is called cash inflow, and money going out from the business is called cash outflow.

13. Method of Analysis

To measure performance of companies, this study will consider liquidity and asset management ratio, adopting cash flow ratios and accrual basis ratio. The formulae for cash flow basis ratio were adopted from both Beevers (1966) and Gilbert et-al studies investigation on cash flow information as prediction for corporate failure. See below for the formulae

For the accrual accounting ratios and cash flow ratios, liquidity ratios were measured based on the following formulas in the table below;

Table 2

Ratios for Financial Analysis-Liquidity Ratios.

No.	Traditional Ratios	Cash Flow Ratios
1.	Current Ratio: Current Assets Current liabilities	Cash to Debt: Cash flow from operations Total debt
2.	Quick Ratio: Current assets-Inventory Current Liabilities	Critical needs: Cash Flow from operations-interest paid Interest + current debt + dividends

Source: Adapted from Beaver (1966), Gombola and Ketz (1993), Foster (1986), Gilbert et al (1990), Figlewicz and Zeller (1991), Carslaw and Mills (1993), Giacomino and Mielke (1993), Koen et al, (1994), Zeller and Stanko (1994b), Mills and Yamamura (1998) and Lovemore and Brummer, (2003)

Table 3
Asset management ratios formular are shown below:

No.	Traditional Ratios	Cash Flow Ratios
1.	Fixed asset turnover: Turnover Current liabilities	Cash to asset: Cash flow from operations Total fixed assets
2.	Total asset turnover: Turnover Total assets	Reinvestment: Cash Flow from operations Total assets

Source: Adapted from Gombola and Ketz (1987s), Foster (1986), Gilbert et al. (1990), Figlewicz and Zeller (1991), Carslaw and Mills (1993), Giacomino and Mielke (1993, Mills and Yamamura (1998) and Sharma (2001).

Ratios for asset management

14. COMPARATIVE ANALYSIS OF RATIOS ADOPTING BOTH CASHFLOW STATEMENT AND ACCRUAL ACCOUNTING BASIS

14.1 Liquidity ratio measured based on Accrual basis shown below:

$$\text{Current (current working capital) Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{49500}{4500} = 11:1$$

$$\text{acid test ratio i.e. current asset stock} = \frac{45000 - 14000}{4500} = \frac{35500}{4500} = 7.89:1$$

14.2 Liquidity ratio measured based on cash flow basis are stated below

$$\text{Cash debt ratio} = \frac{\text{cash flow from operation}}{\text{total debt}} = \frac{5800}{24500} = 0.2367 = 0.24: 1$$

$$\text{Critical needs ratio} = \frac{\text{CFFO} - \text{Interest paid}}{\text{Current liabilities}}$$

$$\frac{5800 - 5000}{4500} = \frac{800}{4500} = 0.18:1$$

14.3 Asset management ratios computation for both accrual and cashflow basis

Accrual basis ratio:

$$\text{Fixed asset turnover ratio} = \frac{\text{Turnover}}{\text{Fixed assets}}$$

$$\text{ie} \quad \frac{36250}{29,000} = 1.25$$

$$\text{Total asset turnover ratio} = \frac{\text{Turnover}}{\text{Total asset}}$$

$$\text{ie} \quad \frac{36,250}{78,500} = 0.46$$

Cash basis ratio:

$$\text{Cash to fixed asset ratio} = \frac{\text{CFFO}}{\text{Total fixed Assts}}$$

$$\frac{5800}{29,000} = 0.2$$

$$\text{Reinvestment ratio} = \frac{\text{CFFO}}{\text{Total Assets}}$$

$$\frac{5800}{78,500} = 0.074$$

15. Results

From the ratios computed applying cash flow basis ratio and accrual basis ratio, it could be observed that the liquidity ratios computed using accrual basis were positive and very high i.e. above 1 which is a good indication that the organization solvency/ liquidity position is good. However, when cash flow basis ratios were applied

adopting Beaver formula, the solvency/ liquidity position were all negative. The implication of this is that the organization may likely not be able to meet its daily obligations and this will affect its operation and may lead to corporate bankruptcy and liquidation. More so, the asset management ratio computed based on accrual basis showed efficient asset management while this in the real sense is not true.

16. Conclusion

This study concludes that for organization management to make good decision. There is need for appraising corporate performance (liquidity/ asset management) using cash flow basis statement ratio since this will give better information on corporate performance in relation to organizational liquidity and viability unlike the accrual basis which does not give a good insight of the corporate performance rather applies past cost which most times does not consider inflation (ie changes in value for money) when appraising corporate performance.

17. Recommendations

This study recommends that there is need for users of accounting information to appraising corporate performance applying cash basis ratio, as this is a better tool than accrued financial statement.

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Appendix I

The balance sheets of Fabis Ltd for the years ended 31st December 1991--1992 were summarised as shown below

	1991 N,000	1992 N,000
Ordinary shares of N1 per share	60,000	50,000
Reserves:		
Profit and Loss	5,000	4,000
Creditors due in less than one year		
Trade Creditors	4,000	2,500
Taxation	1,500	1,000
Proposed dividends	2,000	1,000
Creditors due in less than one year		
	<u>15,000</u>	<u>20,000</u>
10% debenture	87,500	78,500
Fixed assets (at written down values):		
Premises	10,000	10,000
Fixtures	17,000	11,000
Vehicles	12,500	8,000
Current assets:		
Stock	17,000	14,000
Debtors	8,000	6,000
	<u>23,000</u>	<u>29,500</u>
Bank and cash	87,500	78,500

Note: (1) The 10% debentures were redeemed and cancelled on 31 December 19-2

(2) Income tax and advance corporation tax has been ignored.

The profit and loss account for fabis Ltd for the year ended 31 December 1992 was summarised thus

	N,000	N,000
Turnover		36,250
Cost of Sales		(21,750)
Gross Profit		<u>14,500</u>

Profit on disposal of vehicles		700
		15,200
Less		
Wages and salaries	1,600	
Other (cash) expenses	3,600	
Depreciation	3,500	
Debenture Interest	2,000	
		10,700
Profit before tax		4,500
Less		
Tax		1,500
Profit after tax		3,000
Less		
Proposed dividends		2,000
Retained profit for year		1,000
brought forward		4,000
Carried forward		5,000

Separate bank and cash accounts for Fabis Ltd for the year ended 31 December 1992 were summarised

	Bank N,000	cash N,000		Bank N,000	Cash N,000
Opening balance b/d	25,30				
	0	4,200	Payments to trade		
	30,50				
Receipts from debtors	0	3,750	creditors	23,250	-
Receipts from fixed			Wages, Salaries	700	900
asset isposals -vehicled	1,200	500	Other expenses	2,400	1,200
	10,00				
Ordinary share issue	0	-	Debenture interest	2,000	
Transfer from cash	4,650	-	Fixed assets		
			Fixtures	7,000	-
			vehicles	8,000	
			Tax paid	1,000	
			Dividends paid		
			10% debenture		
			redeeme		
			d	5,000	
			Transfer to bank		4,650
	71,65	8,450	Closing balances c/D	21,300	1,700
	0	8,450		71,650	8,450
Opening balances	21,30				
b/d	0	1,700			

Source: Jennings A.R. (1993)

Information and data given above is used to produce the cash flow statement shown below
 fabis Ltd cash flow statement for the year ended 31 December 2013

	N,000	N'000
Net cash inflow operating activities		
Returns on investments and servicing and servicing of Finance		5,800
Interest paid	(2,000)	
Dividends paid	(1,000)	
Net cash inflow from returns on investments and servicing of finance		
Taxation		(3,000)
Corporation tax paid	(1,000)	
Tax paid		(1,000)
Investing activities:		
Payments to acquire tangible fixed assets (7,000 + 8,000)	(15,000)	
Receipts from sale of tangible fixed assets (1,200+500)	1,700	
Net cash outflow from investing activities		(13300)
Net cash outflow before financial Financing		(11,500)
Issue of ordinary share capital	10,000	
Redemptipon of 10% debentures	(5,000)	
Net cash inflow financing		5,000)
Decrease in cash and cash equivalents		(6,500)

N,000

Note: As an alternative, the first item on the above statement may be expanded to show cash inflows and outflows in detail, thus

Operating activities		
Cash received from customers (30,500 +3,750)		34,250
cash payments to suppliers		(23,250)
Cash paid to and on behalf of employees (700+900)		(1,600)
Other cash payments (2,400+1,200)		(3,600)
Net cash inflow from operating activities		5,800

The requisite essential notes, shown in proforma is shown below:

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Notes: to the cash flow statement

1. Reconciliation of operating profit to net cash inflow from operating activities

	N,000
Operating profit (4,500 (PBT) + 2,000 (Deb. Int.)	6,500
Depreciation charges	3,500
Profit on disposal of tangible fixed assets	(700)
Increase in stocks (17,000 -14,000)	(3,000)
Increase in debtors (8,000-6,000)	(2000)
Increase in creditors (4,000-2,500)	1,500
Net cash inflow from operating activities	5,800

2. Analysis of changes in cash and cash equivalents during the year

	N,000
Balance at 1 January 1992	29,500
Net cash outflow	(6,500)
Balance as at 31st Dec. 1992	23,000

3. Analysis of the balances of cash and cash equivalents as shown in the balance sheet

	1991 ₹,000	1992 ₹,000	Change in year ₹,000
cash at abnk and in hand	23,000	29,500	(6,500)
short-term investments	Nil	Nil	Nil
Bank overdrafts	Nil	Nil	Nil
	<u>23,000</u>	<u>29,500</u>	<u>(6,500)</u>
4. Analysis of changes in financing during the year			
	Share Capital ₹,000	Debenture loan ₹,000	
Balance at 1 January 2012	50,000	20,000	
Cash inflow (outflow) from financing	<u>10,000</u>	<u>(5,000)</u>	
Balance as at 31 December 1992	60,000	15,000	