BY
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FRS 102: The Statement of Cash Flows

This article sets out the requirements under the new standard and the differences between FRS 102 and the previous standard, FRS 1 Cash Flow Statements (FRS 1).

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Introduction

Under 'old' Irish GAAP many reporting entities were given exemption from preparing cash flow statements but under FRS 102 a complete set of financial statements must now include a cash flow statement for accounting periods commencing on or after 1st January 2015. This article sets out the requirements under the new standard and the differences between FRS 102 and the previous standard, FRS 1 Cash Flow Statements (FRS 1).

Classifications of Cash Flows

Under FRS 1 Cash Flow Statements reporting entities preparing a cash flow statement had to classify their cash flows under nine headings as follows:

- Operating activities
- Dividends from joint ventures and associates
- Returns on investments and servicing of finance
- Taxation
- Capital expenditure and financial investments
- Acquisitions and disposals
- Equity dividends paid
- Management of liquid resources; and
- Financing

However, Section 7 to FRS 102 now requires the statement of cash flows to be prepared using only the following three headings:

- Operating activities
- Investing activities
- Financing activities

Operating activities are the day-to-day revenue-producing activities that are not investing or financing activities. This category is essentially a 'default' category which encompasses all cash flows that do not fall within investing or financing classifications. Section 7.4 to FRS 102 provides various examples of cash flows arising from operating activities as follows:

- Cash receipts from the sale of goods and the rendering of services
- Cash receipts from royalties, fees, commissions and other revenues
- Cash payments to suppliers for goods and services
- Cash payments to and on behalf of employees
- Cash payments or refunds of income tax, unless they can be specifically identified with financing and investing activities
- Cash receipts and payments from investments, loans and other contracts held for dealing or trading purposes, which are similar to inventory acquired specifically for resale
- Cash advances and loans made to other parties by financial institutions

One key problem that arises is how to deal with corporation tax. Corporation tax paid during a year would have been included in the separate taxation heading under FRS 1. However, under FRS 102, it is included within operating activities provided that the tax is not attributable to any investing or financing activities thus any tax on capital gains would have to be allocated to investing activities as that is where the proceeds on disposal of property would be reported. The tax must be recorded with the cash income to which they relate.

Another issue is interest paid and received which would have been recorded in *Returns on investment and servicing of income* under FRS 1. Both can now be recorded within any of the three headings although in listed companies most companies argue that any interest paid would be used mainly to support operating activities and interest received is a return from investing activities.

Another issue that preparers of statements of cash flow will have to consider is whether or not to adopt the direct or the indirect method of reporting operating cash flows. Under FRS 1 the indirect method was compulsory so the direct method was rarely seen in local reporting, as an additional option. Now, under FRS 102, there is a clear choice between the two methods. From the preparers' point of view the indirect method is easier as it takes the operating profit as its starting point and then indirectly adjusts for non cash transactions included in arriving at operating profit e.g. depreciation, profits/losses on disposal of fixed assets etc as well as adjusting for the movements in working capital. This reconciliation may be reported on the face of the Statement of Cash Flows or, my preference, to remove it into the notes thereby ensuring that only actual cash movements are reported on the face of the statement.

On the other hand, the direct method identifies the actual cash received from customers and the actual cash paid to suppliers and employees. This is more user friendly from the average reader''s perspective but it is more difficult to prepare as it requires adjustments for non cash movements to be removed from the movements in working capital items. It is likely, however, that the International Accounting Standards Board (IASB) will in the not too distant future make the direct method compulsory because of its ease in being more easily understood by users.

Illustrative Example – Direct Method

Prepare the cash flows from operating activities section of cash flow statement by direct method using the following information:

December 31	2016	2015
Trade debtors	€34,130	€28,410
Prepaid Rent	20,000	25,000
Prepaid Insurance	6,800	6,000
Stocks	23,030	15,450
Trade creditors	14,590	31,300
Salaries Payable	8,310	5,120
Interest Payable	700	360
Corporation Tax Payable	2,340	0

Year Ended December 31	2016
Sales	64,970
Salaries Expense	8,610
Rent Expense	5,000
Insurance Expense	3,200
Interest Expense	1,650

Solution

Cash Flow from Operating Activities	
Cash Receipts	
From Customers (1)	€59,250
	(64,970 + 28,410 – 34,130)
Cash Payments	
To Suppliers (2)	(24,290)
	(23,030 – 15,450 + 31,300 – 14,590)
To Employees (3)	(5,420)
	(5,120 – 8,310 + 8,610)
For Purchase of Prepaid Assets (4)	(4,000)
	(20,000 + 6,800 + 5,000 + 3,200 - 25,000 - 6,000)
Interest (5)	(1,310)
	(360 - 700 + 1,650)
Income Tax (6)	(0)
	(0 - 2,340 + 2,340)
Net Cash Flow from Operating Activities	**24,230**

Illustrative Example – Indirect Method

Use the following information to calculate net cash flow from operating activities using the indirect method:

	€
Net Profit	7,000
Depreciation Expense	1,000
Increase in Trade debtors	4,400
Increase in Prepaid Rent	7,000
Decrease in Prepaid Insurance	1,300
Increase in Trade creditors	14,000
Increase in Wages Payable	1,000
Decrease in Income Tax Payable	700
Gain on Sale of Equipment	1,800

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Solution

Cash Flows from Operating Activities:	€
Net Profit	7,000
Depreciation Expense	1,000
Gain on Sale of Equipment	(1,800)
Increase in Accounts Receivable	(4,400)
Increase in Prepaid Rent	(7,000)
Decrease in Prepaid Insurance	1,300
Increase in Accounts Payable	14,000
Increase in Wages Payable	1,000
Decrease in Income Tax Payable	(700)
Net Cash Flow from Operating Activities	**10,400**

Investing activities are those activities which involve the acquisition and disposal of long-term assets – for example monies used for the purchase of fixed assets and cash receipts from the disposal of such assets. In addition to cash payments to acquire and cash receipts in respect of the disposal, of fixed assets, paragraph 7.5 to FRS 102 gives further examples of activities that would typically fall under investing activities:

- Cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments classified as cash equivalents or held for dealing or trading)
- Cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments classified as cash equivalents or held for dealing or trading)
- Cash advances and loans made to other parties (except those made by financial institutions)
- Cash receipts from the repayment of advances and loans made to other parties
- Cash payments for futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading, or the payments are classified as financing activities
- Cash receipts from futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading, or the receipts are classified as financing activities

Financing activities are those activities that change the equity and borrowing composition of the company. This can include the cash proceeds received by the company for issuing additional shares or the proceeds received from the raising of a loan. In addition to funds received for issuing shares and raising loans, paragraph 7.6 to FRS 102 includes examples of cash flows that would appear under financing activities as follows:

- Cash payments to owners to acquire or redeem the entity's shares
- Cash proceeds from issuing debentures, notes, bonds, mortgages and other short-term or long-term borrowings
- Cash repayments of amounts borrowed
- Cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease

Cash and Cash Equivalents

Unlike FRS 1 which reconciles the movement in cash to the opening and closing cash and bank balances FRS 102 reconciles to the opening and closing cash and cash equivalents.

"Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Bank overdrafts are normally considered financing activities similar to borrowings. However, if they are repayable on demand and form an integral part of an entity's cash management, bank overdrafts are a component of cash and cash equivalents"

In the past cash equivalents would be fairly similar to what were termed liquid resources in FRS 1.

Dividends

Under FRS 1, dividends paid are disclosed in the cash flow statement under equity dividends paid. However, Section 7 to FRS 102 considers dividends as either operating or financing cash flows. In general, paragraph 7.14 requires a company to present cash flows from dividends both paid and received separately and consistently from one period to the next as either operating, investing or financing cash flows.

Dividends received could be classified by a client as operating cash flows because they are included in profit or loss. Alternatively, they may be classified as financing cash flows if they are regarded as returns on investments.

Dividends paid to shareholders may be classed as financing activities because they are a cost of obtaining financial resources. However, FRS 102 does permit an entity to classify dividends paid as a component of cash flows from operating activities on the grounds that they are paid out of operating cash flows.

Comprehensive Illustrative Example using the Indirect Method

As the indirect method is still likely to be the more popular of the two methods of reporting operating cash flows the example below adopts that methodology.

The following are extracts from the draft financial statements of Kircubbin plc for the year ended 30 June 2016.

Statement of Profit or Loss for the year ended 30 June 2016 (extract)

	€
Profit from operation	297,380
Finance cost	(164,000)
Profit before tax	133,380
Income tax expense	(30,780)
Profit for the period	**102,600**

Statement of Financial Position as at 30 June 2016

	2016 €	2015 €
ASSETS		
Non-current assets		
Property, plant and equipment	383,900	366,500
Intangible assets	1,163,300	1,245,000
	1,547,200	1,611,500
Current assets		
Inventories	123,100	106,000
Trade and other receivables	229,800	216,500
Cash and cash equivalents	88,000	59,300
	440,900	381,800
Total assets	**1,988,100**	**1,993,300**

EQUITY AND LIABILITIES

Equity		
Ordinary share capital (€1 shares)	680,000	550,000
Share premium account	170,000	110,000
Retained earnings	421,300	352,700
	1,271,300	1,012,700
Non-current liabilities		
Borrowings	350,000	600,000
Current liabilities		
Trade and other payables	334,800	358,600
Income tax payable	32,000	22,000
	366,800	380,600
Total equity and liabilities	**1,988,100**	**1,993,300**

The following additional information is also relevant:

1. During the year plant was sold and a loss of €11,000 was recognised in the income statement. The plant had an original cost of €90,000 and a carrying amount of €35,000 at the date of disposal. At 30 June 2016, half of the disposal proceeds had not been received and were included in trade and other receivables.
2. On 1 July 2015 new equipment was acquired with a fair value of €89,000. An initial deposit of €50,000 was paid at that date and the balance due was included in trade and other payables. Deferred credit terms of 12 months were granted on the balance. This balance plus accrued interest of €1,700 was paid on 1 July 2016.
3. Trade and other payables include accrued interest payable of €6,300 (2015: €7,500) which includes the €1,700 interest payable referred to in (2) above.
4. During the year a brand was acquired from Ards Ltd, for €200,000. Cash of €100,000 was paid and the balance was settled by the issue of 50,000 €1 ordinary shares in Kircubbin Plc with a fair value of €2 each. The remaining movement in intangible assets relates to amortisation charged during the period.
5. During the year Kircubbin plc issued ordinary shares for cash in addition to the shares issued to Ards Ltd.
6. During the year Kircubbin plc declared and paid an interim dividend.

Solution

Kircubbin plc

Statement Cash Flows for the year ended 30 June 2016

	€	€
Cash flows from operating activities		
Cash generated from operations (Note)	546,680	
Interest paid (W1)	(165,200)	
Income tax paid (W2)	(20,780)	
Net cash from operating activities		360,700
Cash flows from investing activities		
Purchase of property, plant and equipment	(50,000)	
Purchase of intangible assets	(100,000)	
Proceeds from sales of property, plant and equipment (35,000 – 11,000) / 2	12,000	
Net cash used in investing activities		(138,000)
Cash flows from financing activities		
Proceeds from issue of ordinary share capital (80,000 (W5) + 10,000 (W6))	90,000	
Repayment of loan (600,000 – 350,000)	(250,000)	
Dividends paid (W7)	(34,000)	
Net cash from financing activities		(194,000)
Net increase in cash and cash equivalents		28,700
Cash and cash equivalents at beginning of period		59,300
Cash and cash equivalents at end of period		**88,000**

Reconciliation of profit before tax to cash generated from operations

	€
Profit before tax	133,380
Finance costs	164,000
Depreciation charge (W3)	36,600
Amortisation charge (W4)	281,700
Loss on disposal of property, plant and equipment	11,000
Increase in inventories (123,100 – 106,000)	(17,100)
Increase in trade and other receivables ((229,800 – 12,000) – 216,500)	(1,300)
Decrease in trade and other payables ((334,800 – 6,300 – 39,000) – (358,600 – 7,500))	(61,600)
Cash generated from operations	**546,680**

Workings

(1) Interest paid

	€		€
Cash (β)	165,200	B/d	7,500
C/d	6,300	IS	164,000
	171,500		171,500

(2) Tax paid

	€		€
Cash (β)	20,780	B/d	22,000
C/d	32,000	IS	30,780
	52,780		52,780

(3) Property, plant and equipment

	€		€
B/d	366,500	Disposal	35,000
		Depreciation (β)	36,600
Additions	89,000	C/d	383,900
	455,500		455,500

(4) Intangibles

	€		€
B/d	1,245,000	Amortisation (β)	281,700
Additions	200,000	C/d	1,163,300
	1,445,000		1,445,000

(5) Share capital

	€		€
		B/d	550,000
Non-cash issue			50,000
C/d	680,000	Cash (β)	80,000
	680,000		680,000

(6) Share premium

	€		€
		B/d	110,000
Non-cash issue			50,000
C/d	170,000	Cash (β)	10,000
	170,000		170,000

(7) Retained earnings

	€		€
Dividends in SCE (β)	34,000	B/d	352,700
C/d	421,300	IS	102,600
	455,300		455,300

Conclusion

The cash flow statement is one of the primary financial statements under FRS 102 that is going to need a lot of thought devoted to it in terms of how to classify cash flows as there are significantly less cash flow classifications under Section 7 than there are under current FRS 1. In addition, preparers might seriously consider adopting the more user friendly direct method of reporting operating cash flows.