



# **Manage the Finance**

## **Handout 7**

### **Concepts for Cashflow Projections**

## CONCEPTS FOR CASHFLOW PROJECTIONS

### 1. Cash

Cash, for the purpose of this statement, is cash at bank and on hand and any other highly liquid investment that are **readily retainable** to known amounts of cash.

### 2. Funds

Funds can be defined as the financial resources possessed by a company and which now from transactions concluded **third parties**. This means that there can only be a flow of funds if a transaction occurs between the business and a person outside the business. Your main task will be to determine whether there was an inflow or outflow of funds during the past financial year. One can say that the concepts cash and funds go hand in hand.

### LET US DEMONSTRATE

The following comparative figures in the financial statement of Zippa LTD are given to you:

	2008	2007
1. Land and Buildings	150 000	100 000
2. Vehicles	80 000	90 000
3. Inventory	90 000	110 000
4. Debtors	40 000	60 000
5. Creditors	50 000	45 000
6. Ordinary share capital	200 000	180 000

## REQUIRED

Indicate for each item whether it is an inflow or outflow of funds.

## SOLUTIONS

### 1. LAND AND BUILDINGS

To determine whether it was an inflow or outflow of funds one must compare the figures for this year with the previous year. Because there was an increase of R 50 000 one can say that more buildings were bought. Therefore, the increase of R50 000 in Land and Buildings will be an outflow of funds.

### 2. VEHICLES

The decrease of R10 000 in vehicles means that vehicles were sold during the past financial year. This means an inflow of funds.

### 3. INVENTORY

The decrease of R20 000 in stock means that more stock was sold during the past financial year. This means an inflow of funds.

### 4. DEBTORS

The decrease of R20 000 in debtors means that more debtors paid their debts during the past financial year. This means an inflow of funds.

### 5. CREDITORS

The increase of R5 000 in creditors means that more credit facilities were received from creditors (more credit purchases). This means an inflow of funds although your liabilities increased.

### 6. ORDINARY SHARE CAPITAL

The increase of R20 000 in the share capital means that more shares were issued during the past financial year which indicates that the company received cash. This means an inflow of funds.

## 3. Investment Activities

Investment activities are those activities relating to the acquisition and disposal of fixed assets and investments. You are referred to the increase of R50 000 IN Land and Buildings and the decrease of R10 000 in vehicles in the previous example.

What will an increase in investments be?

## EXAMPLE

	2008	2007
Investments	20 000	10 000

The increase of R10 000 in investments means that more money was invested in a business outside our business. This means an outflow of funds. The opposite, namely a decrease in investments, will be an inflow of funds.

### 4. Financing activities

Financing activities are those activities which result in changes in the size and composition of the debt and capital funding of the business. In other words, the financing activities indicate where the funds were obtained from to finance the investment activities and daily operating activities. The increase in R20 000 in the Ordinary share capital is a good example of financing activity (example to explain the concept funds).

Will an increase in long term liabilities be an inflow or outflow of funds?

Yes, it will be an inflow of funds because more money is borrowed from outside the business.

### 5. Operating activities

Operating activities include all transactions and other events that are not investing and financing activities. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of income.

Examples of these type of activities are:

- Dividends paid for the year
- Taxation paid for the year and
- Interest paid (finance cost) for the year

In our discussion later you will see that the information for operating activities is found in the Income Statement.

## 6. Cash flows from operating activities

The cash flows from operating activities represent the first section of the Cash Flow Statement. In this section all those items which have an effect on the determination of income will be taken into account. The following items are involved.

- Investment income for example dividends received
- Financing charges for example interest paid
- Taxation paid
- Dividends paid
- Changes in working capital which consist of:
  - Increase/decrease in inventory
  - Increase/decrease in debtors
  - Increase/decrease in creditors
- Profit before taxation adjusted with all the non-cash flow items

What is the meaning of the concept non-cash flow items?

**Non-Cash Flow** items are all those items that have an influence on the profit but that are not a flow of funds because no third party is involved.

The following are examples of non-cash flow items:

- Profit or Loss on disposal of a fixed asset
- Depreciation
- Increase or decrease in the provision for bad debts
- Transfer to reserves

Did you recognise that the majority of the information for this section can be found in the Income Statement? It is only the changes in working capital that are found in the Balance Sheet. Although these changes did not influence the profits directly it must be taken into account in this section because the changes are part of the operating activities of the business.

## 7. Cash flows from investment activities

The cash flows from investment activities represent the second section of the Cash Flow Statement. In this section all those items which have an effect on the acquisition and disposal of fixed assets and investments will be taken into account. In other words, this section indicates how the funds were utilised to maintain or to expand operations

The following items are involved:

- Replacement of fixed assets
- Proceeds on the disposal of fixed assets
- Additions to fixed assets
- Investments purchases
- Investments sold

Did you recognise that the information for this section can be in the notes for plant, machinery and equipment (Fixed assets) and Investments? The comparative figures of the previous year must be taken into account to determine the inflow or outflow of funds. (See our discussion later).

### **8. Cash flows from financing activities**

The cash flows from financing activities represent the third section of the Cash Flow Statement. In this section all those items which have an effect on the debt and capital funding of the business, will be taken into account. In other words, this section indicates where the funds were obtained from to Finance the investment activities and the daily operating activities.

The following items are involved:

- Increase or decrease in long term borrowings
- Proceeds from issue of share capital
- Increase in share premium

Did you recognise that the information for this section can be found in the equity and liabilities section of the Balance Sheet? You must determine whether the increase or decreases from the previous year's figures are an inflow or outflow of funds.

### **Calculations of certain concepts**

Before we discuss the format of the Cash Flow Statement according to AC I 18 we are first going to discuss how to calculate the following concepts:

- Cash flows from operating activities
- Cash flows from investment activities
- Cash flows from financing activities

To explain the calculations of these concepts only one example will be used.

## LET US DEMONSTRATE

The following information was obtained from the financial statements of SAICA (LTD) at 31 March 2008.

<b>INCOME STATEMENT FOR THE YEAR ENDED 31 MARCH 2008</b>	
Turnover	96 000
Cost of Sales	62 400
Gross Profit	33 600
Other operating income: Profit ON disposal of asset	1300
Investment Income	389
Dividends received	164
Interest received	225
Operating costs	(20 089)
Depreciation	12 295
Auditor's remuneration	2 000
Administrative expenses	5 794
Profit on ordinary activities before interest	15 200
Interest paid	(3 200)
Profit on ordinary activities before taxation	12 000
Taxation	(5 400)
Profit on ordinary activities after taxation	6 600
Preference dividend	400)
Profit attributable to ordinary shareholders	6 200
Ordinary dividends	(1 000)
Transfer to general reserves	(2 800)
Retained profit for the year	2 400
Retained earnings- beginning of the year	3 180
Retained earnings- end of the year	5 580

## BALANCE SHEET AT 31 MARCH 20X8

<b>ASSETS</b>	2008	2007
Non-Current assets	126 800	116 000
Fixed Assets (See Note)	121 800	114 500
Investments in shares at cost	5 000	1 500
Current assets	44 680	46 400
Inventory	19 300	21 850
Debtors	25 380	22 750
Bank		1 800
	171 480	162 400
<b>EQUITY AND LIABILITIES</b>		
Capital and reserves	97 380	81 180
Ordinary share capital	33 000	26 000
Preference share capital	6 000	4 000
Share premium	20 000	18 000
Non-distributable reserves	10 000	10 000
Distributable reserves	28 380	23 180
General Reserves	22 800	20 000
Retained income	5 580	3 180
Non-current liabilities	41 280	47 120
Non-current loan	21 000	29 000
Debentures	20 280	18 120
Current liabilities	32 820	34 100
Creditors	25 870	27 500
SARS	5 400	6 000
Shareholders for dividends	300	600
Bank overdraft	1 250	
	171 480	162 400



## ADDITIONAL INFORMATION

### I. FIXED ASSETS/TANGIBLE ASSETS

**2008**

	Land and Building	Plant	Equipment	Total
Gross carrying value	17 100	118 500	4 330	139 930
Acc depreciation	1 100	16 700	330	18 130
Opening balance	420	5 270	145	5 835
Depreciation	680	11 430	185	12 295
Net carrying value	<b>16 000</b>	<b>101 800</b>	<b>4 000</b>	<b>121 800</b>

**2007**

	Land and Building	Plant	Equipment	Total
Gross carrying value	14 420	103 770	3 645	120 335
Acc depreciation	420	6 770	145	5 835
Opening balance	140	3 000	45	1 685
Depreciation	280	3 770	100	4 150
Net carrying value	<b>14 000</b>	<b>97 000</b>	<b>3 500</b>	<b>114 500</b>

2. Plant with a cost price of R2 080 and a net carrying value of R580 was sold for R1 880. Plant purchased was in replacement of the plant sold.

### REQUIRED

Calculate the following:

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

## SOLUTION

### I. CASH FLOWS FROM OPERATING ACTIVITIES

Profit before taxation	12 000
Adjust for:	
Depreciation	12 295
Interest paid	3 200
Profit on disposal of Plant	(1 300)
Investment income	389
Operating profit before changes in working capital	<u>25 806</u>
Changes in working capital	(1 710)
Decrease in inventory (21 850-19 300)	2 550
Increase in debtors (25 380-22 750)	(2 630)
Decrease in creditors (27 500-25 870)	(1 630)
Cash generated by operations	<u>24 096</u>
Investment income	389
Interest paid	(3 200)
Taxation paid (6 000+5 400-5 400)	(6 000)
Dividends paid (600+1 400-300)	(1 700)
	<u><u>13 585</u></u>

## EXPLANATION

- Depreciation is added back because it is not a flow of funds and because it originally decreased the profit.
- Profit on disposal of Equipment is another item that is not a flow of funds. Therefore, it must be subtracted because it originally increased the profit.
- The only reasons to subtract the investment income and to add the interest paid are because they both influenced the profit before taxation, and both have their own heading in the calculation of the cash flows from operating activities.
- The taxation paid, and dividends paid can also be calculated as follows:

- Taxation

Unpaid amounts at beginning of year	6 000
Amount in Income Statement	5 400
Unpaid amounts at the end of the year	(5 400)
	<b>6 000</b>

**Dividends**

Unpaid amounts at beginning of year	6 00
Amount in Income Statement (Ordinary + Preference)	1400
Unpaid amounts at the end of the year	(3 00)
	<b>6 000</b>

- The amounts in brackets indicate an outflow of funds except for the adjustments to the profit before taxation.

## 2. CASH FLOWS FROM INVESTMENT ACTIVITIES

Investments to maintain operating capacity	(14 930)
Replacement of plant	(16 810)
Proceeds on disposal of plant	1 880
Investments to expand operating capacity	(6 865)
Additions to Land and buildings	(2 680)
Additions to Equipment	(68 5)
Investments purchased	(3 500)
	<u>(21 795)</u>

### EXPLANATION

- The replacement of the Plant can be calculated using the following “T” account.

Plant			
Balance	103 770	Asset disposal	2 080
*Purchase	16 810	Balance	118 500
	<u>120 580</u>		<u>120 580</u>

\*The purchases are the balancing figure on the Plant account

- Because there was no Land and Buildings and Equipment sold the difference in their cost prices from the previous year indicates the additions to these assets.
- Remember an increase in investments indicates that more money was invested outside the business. (outflow of funds)

### 3. CASH FLOWS FROM FINANCING ACTIVITIES

Decrease in long term loans	(8 000)
Proceeds from Ordinary shares issued (7 000+ 2 000)	9 000
Proceeds from Preference shares issued	2 000
Proceeds from Debentures	2 160
	<hr/>
	5 160
	<hr/> <hr/>

#### EXPLANATION

- A decrease in non-current loans indicates an outflow of funds. Money was paid to a third party outside the business.
- The increase in the share premium (R2 000) must be included in the proceeds from the Ordinary shares issued. The R2 000 is part of the cash received when the shares were issued.

#### FORMAT CASH FLOW STATEMENT AC 118

The Cash Flow Statement of a Company must be prepared according to the requirements of Statement AC 118 of the Public Accountants and Auditors Board. As we have indicated before there are two methods namely the indirect and direct method. In this chapter we are going to concentrate on the direct method only as this is the suggested format to use in practice.

## LET US DEMONSTRATE

The following information was obtained from the financial statements of Mamoek Limited at 31 March 2008.

### INCOME STATEMENT FOR THE YEAR ENDED 31 MARCH 2008

	R '000	
Gross turnover	96 000	
Cost of Sales	(62 400)	
Gross Profit	<hr/> 33 600	
Other operating income	1 300	
Profit on disposal of Plant	<table border="1"><tr><td>1 300</td></tr></table>	1 300
1 300		
Investment income	389	
Dividends received	<table border="1"><tr><td>164</td></tr></table>	164
164		
Interest received	<table border="1"><tr><td>225</td></tr></table>	225
225		
Operating costs	(20 089)	
Depreciation	<table border="1"><tr><td>12 295</td></tr></table>	12 295
12 295		
Auditor's remuneration	800	
Director's remuneration	1 200	
Administrative expenses	<table border="1"><tr><td>5 794</td></tr></table>	5 794
5 794		
Profit on ordinary activities before interest	15 200	
Interest paid	(3 200)	
Profit on ordinary activities before taxation	<hr/> 12 000	
Taxation	(5 400)	
Profit on ordinary activities after taxation	<hr/> <hr/> 6 600	

**BALANCE SHEET AT 31 MARCH 2008**

	<b>2008</b>	<b>2007</b>
	R'000	R'000
<b>ASSETS</b>		
Non-current assets	126 800	116 000
Fixed assets	121 800	114 500
Investments in shares at cost	5 000	1 500
Current assets	44 680	46 400
Inventory	19 300	21 850
Debtors	25 380	22 750
Bank		1 800
	<b>171 480</b>	<b>162 400</b>
<b>EQUITY AND LIABILITIES</b>		
Capital and Reserves	97 380	81 810
Ordinary share capital	33 000	26 000
Preference share capital	6 000	4 000
Share premium	20 000	18 000
Non-distributable reserves	10 000	10 000
Distributable reserves	28 380	23 180
General reserve	22 800	20 000
Retained income	5 580	3 180
Non-current liabilities	41 280	47 120
Long term loan	21 000	29 000
Debentures	20 280	18 120
Current liabilities	32 820	34 100
Creditors	25 870	27 500
Receiver of Revenue	5 400	6 000
Shareholders for dividends	300	600
Bank overdraft	1 250	
	<b>171 480</b>	<b>162 400</b>

## ADDITIONAL INFORMATION

### I. FIXED ASSETS

2008 (R'000)

	Land and			
	Building	Plant	Equipment	Total
Gross carrying alue	17 100	118 500	4 330	139 930
Acc Depreciation	1 100	16 700	330	18 130
Opening balance	420	5 270	145	5 835
Depreciation	680	11 430	185	12 295
Net carrying value	<b>16 000</b>	<b>101 800</b>	<b>4 000</b>	<b>121 800</b>

2007 (R'000)

	Land and			
	Building	Plant	Equipment	Total
Gross carrying value	14 420	770	3 645	12 335
Acc Depreciation	420	6 770	145	5 835
Opening balance	140	3 000	45	1 685
Depreciation	280	3 770	100	4 150
Net carrying value	<b>14 000</b>	<b>97 000</b>	<b>3 500</b>	<b>114 500</b>

2. Plant with a cost price of R2 080 (R'000) and a net carrying value of R580 (R'000) was sold for R1 880 (R'000). Plant purchased was in replacement of the plant sold.



## **REQUIRED**

Prepare the Cash Flow Statement of Mamoek LTD for the year ended 31 March 2008 using both methods (indirect and direct).

## **SOLUTION**

### **VERY IMPORTANT**

Did you notice that the information given in Mamoek (LTD) is exactly the same as the information given in SAICA (LTD)? This means that we have already calculated the cash flows from operating activities, from investment activities and from financing activities. All that remain now is to put them together in the correct format according to the requirements of Statement AC 118.

**MAMOEK LTD**

**CASH FLOW STATEMENT FOR THE YEAR ENDED 31 MARCH 2008**

	Note	R'000
Cash flows from operating activities		13 585
Cash receipts from customers		93 370
Cash paid to suppliers and employees		(69 274)
Cash generated from operations	1	24 096
Interest received		225
Dividends received		164
Interest paid		(3 200)
Taxation paid (6 000+5 400-5 400)		(6 000)
Dividends paid (600+1 400-300)		(1 700)
Cash flows from investment activities		(21 795)
Purchase of fixed assets/tangible assets		(20 175)
Replacements	2	(16 810)
Additions	3	(3 365)
Proceeds on disposal of fixed assets/tangible assets	4	1 880
Investments purchased		(3 500)
Cash flows from financing activities		5 160
Decrease in long term loans		(8 000)
Proceeds from shares issued	5	11 000
Proceeds from Debentures issued		2 160
Net decrease in cash and cash equivalents		(3 050)
Cash and Cash equivalents at beginning of period		1 800
Cash and cash equivalents at end of period		(1 250)

## NOTES TO THE CASH FLOW STATEMENT

### 1. Reconciliation of net profit before taxation to cash generated from operations.

	<b>R'000</b>
Profit before taxation	12 000
Adjusted for:	
Depreciation	12 295
Interest paid	3 200
Profit on disposal of plant	(1 300)
Investment income	(38 9)
Operating profit before changes in working capital	25 806
Changes in working capital	(1 710)
Decrease in inventory	2 550
Increase in debtors	(2 630)
Decrease in creditors	(1 630)
	<b>24 096</b>

### 2. REPLACEMENT OF FIXED ASSETS/TANGIBLE ASSETS

Plant purchased	16 810
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### 3. ADDITIONS TO FIXED ASSETS/TANGIBLE ASSETS

Land and Buildings purchased	2 680
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Equipment purchased	685
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	3 365
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### 4. PROCEEDS ON DISPOSAL OF FIXED ASSETS/TANGIBLE ASSETS

Carrying value of asset sold	580
Profit on disposal	1 300
Total proceeds	<u>1 880</u>

## 5. PROCEEDS FROM SHARES ISSUED

Ordinary shares	7 000
Share premium on ordinary shares	2 000
Preference shares	2 000
	<u>11 000</u>

### EXPLANATION

1. You are referred to the explanations of the calculations for SAICA LTD
2. The cash received from customers and cash payments to suppliers and employees are calculated as follows:

#### Cash received from customers

Debtors			
Balance	22 750	*Bank	93 370
Sales	96 000	balance	25 380
	<u>118 750</u>		<u>118 750</u>

All the sales are taken into account as credit sales and the bank is the balancing figure.

## Cash payments to suppliers and employees

### Creditors

*Bank	61 480	Balance	27 500
Balance	25 870	Purchases	59 850
	87 350		87 350

- Purchases are determined as follows:

Cost of Sales	62 400
Less: Decrease in inventory	(2 550)
	<b>59 850</b>

- The bank is the balancing figure, but this is only the payment to suppliers. What about the other payments to employees? Therefore, the payment to suppliers and employees are calculated as follows:

Payments to suppliers	R61 480
Payments to employees:	
Auditors' remuneration	800
Directors' remuneration	1 200
Admin expenses	5 794
	69 274