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CASH FLOW STATEMENT

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As several clients requested us to assist them in preparing the Cash Flow Statement (CFS), we decided to dedicate this issue of our newsletter to this subject and to explain the basic logic rule for its compilation.
The concept of cash flow has its origins in the USA where its monitoring was necessitated by capital markets. Financial theory has been interested in cash flow since the beginning of the last century. Later on, in the 60s, it was recommended to extend the financial statements of enterprises by this particular statement. In the USA, cash flow reporting became a mandatory part of the financial statements of enterprises in 1971 (Opinion No. 19). Soon it was adopted in the United Kingdom (1975) and the European Union (1978), where the International Accounting Standard IAS 7 was issued that provides for a uniform reporting of cash flow.

Cash flow (CF) is defined as the actual flow of cash of an enterprise during a specific period in connection with its activities. It is a basis for liquidity management and is used primarily by shareholders and business owners to understand the difference between profit (reported in the Profit and Loss Statement) and free cash (reported in the Cash Flow Statement).

In Slovakia, basic definitions and methods of compilation of the CFS are described in the Measure of the Ministry of Finance No. MF/23377/2014-74 on Preparing the Financial Statements for Large Accounting Entities (Article X of Annex 1). The CFS classifies the cash flows from:

1. Operating activities (income from sales of goods and services, expenditure on payments for the supply of materials, expenditure on staff, etc.);
2. Investment activities (expenditure on acquisition of tangible and intangible assets, income from the sale of such assets, expenditure on borrowing, etc.);
3. Financial activities (income from loans and borrowings provided to the accounting entity by banks, repayment of loans, proceeds from issuing shares, etc.).

The basic methods of reporting CFS for individual activities include:

Operating activities	Investment activities	Financial activities
1. Direct method		
1.1 Net direct method	Direct method	Direct method
1.2 Modified direct method		
2. Indirect method		

When analysing methods of compilation of the CFS by our customers, we found that nearly 97 % of them compile the CFS using the indirect method, which is less demanding in terms of the set-up of accounting programs.

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Under the direct method, gross, i.e. uncompensated revenue and expenditure is reported. The indirect method is based on profit/loss from ordinary activities before the income tax, which is adjusted for:

- Non-cash items;
- Changes in working capital;
- Items included in investment and/or financial activities.

The basic logic rule for preparing the CFS can be generalized as shown below:

ASSET accounts		LIABILITY accounts	
Change in the accounting	**Effect on CFS**	**Change in the accounting**	**Effect on CFS**
FB>IB = +	-	FB>IB = +	+
FB<IB = -	+	FB<IB = -	-
Opposite effect		Identical effect	

Note: FB = Final account balance, IB = Initial account balance, "+" = Increase, "-" = Decrease

When the asset accounts increases (the final account balance is greater than the initial balance), the effect on the compilation of the CFS is opposite, i.e. the cash decreases. When the asset accounts decreases (the final account balance is lower than the initial balance), the effect on the compilation of the CFS is also opposite.

In parallel, we can state that any increase in the liability accounts has the identical effect on the cash flows (CF), i.e. the CF is also increasing. And again, any decrease in the liability account balance has the identical effect on the CF, namely the CF decreases as well.

The most common errors in preparing the CFS include:

- Profit after tax and not the pre-tax profit is used;
- Incorrectly set signs indicating the effect on the CF;
- Reporting of lines that do not have any content;
- Disproportionately high balance in section A.1.3, which refers to "other non-cash items".

Basic requirements to be fulfilled by the accounting entity in preparing the CFS include:

- The CF must be classified by operating, investing and financing activities;
- The CFS must include items reflecting the revenue and expenditure of the accounting entity;
- The CFS must contain data for the current and immediately

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preceding accounting periods;
- Consistency principle;
- Comparability of data for two accounting periods;
- Cash reporting in EUR.

Each accounting entity should have internal regulations setting in particular:

- Method of reporting of the CF from operating activities;
- Level of detail for breaking down individual items;
- Where to recognize the CF that can be recognized in more alternative ways;
- Principles adopted to determine the content and structure of cash funds.

We recommend that the accounting entity includes the following information in the Note section (of the CFS):

- Reasons for any inconsistency between the figures shown in the CFS and the relevant items in the balance sheet;
- Principles used; in the event of any change from the immediately preceding period the respective changes must be specified;
- Method used for reporting CF from operating activities;
- Whether or not the accounting entity reported the net cash and which cash flows were reported as net;
- Any facts that happened during the accounting period in investment and financial activities and have no direct effect on the CF, but may alter the structure of assets, liabilities and equity.

We believe that this subject is of interest to you and that we have, at least partly, answered your questions. If you are interested we can organize a workshop with practical examples to further explain the method of calculation as well as common errors in the compilation of the Cash Flow Statement.

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NOT TO BE MISSED

Important Dates

Overview of important dates in the period from May to June 2016 can be found on our website: **http://www.mandat.sk**

ABOUT US

The companies **MANDAT CONSULTING, k.s.** and **MANDAT AUDIT, s.r.o.** were founded in 2004 as tax advisory and auditing companies. Since their establishment, they have been providing small, medium-sized and companies active in Slovakia with services in the field of tax consultancy, audit and accounting. Long-lasting cooperation with foreign advisory companies hand in hand with the competence of Slovakian tax advisors and auditors enables us rendering our service to the clients originated from abroad.

In present time, 41 well trained members of our staff are at the disposal to our clients.

Information provided in this material are only of a cursory nature. **MANDAT CONSULTING, k.s.** assumes no liability for any decision taken on the basis of this issue.

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