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Cash Flow Statements

This article discusses Cash Flow Statements, firstly from a UK perspective and secondly in relation to Germany. The main differences between UK and German generally accepted accounting practice are also highlighted.

Historically, in the UK, financial statements comprised of only balance sheets and profit and loss accounts. When inflationary pressure took effect there was a need for another statement - the cash flow statement. This statement is often regarded as the most useful for many purposes as it represents the liquidity of the business.

Statement of Standard Accounting Practice No. 10 (SSAP 10) - Source and Application of Funds Statement was an early attempt by UK standard setters of a funds flow statement. This statement was replaced by Financial Reporting Standard No. 1 (FRS 1) - Cash Flow Statements (revised 1996). This change reflected a move from a funds flow to a cash flow approach and was influenced by the International Accounting Standards Committee's (IASC's) standard, International Accounting Standard No. 7 (IAS 7) - Cash Flow Statement.

FRS 1 requires large entities to prepare cash flow statements. Smaller entities are also encouraged to do so but are exempt by companies legislation. The standard's objective is to ensure those within its scope report their 'cash generation and absorption'.

Cash flow statements help users of financial statements to understand performance and position better by disclosing the different cash inflows and outflows. Users are able to use the information for:-

- assessing the current liquidity of a business;
- providing additional information on business activities;
- providing an overview of the major sources of inflow and outflow from the business;
- estimating future cash flows; and
- determining cash flows generated from trading as opposed to the other sources of finance.



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FRS 1 requires entities to report their cash flows under the following standard headings:-

- *operating activities* [represent operating profit adjusted for depreciation, changes in stocks, debtors and creditors];
- *returns on investments and servicing of finance* [includes interest/dividends received and interest paid];
- *taxation* [tax paid];
- *capital expenditure and financial investments* [reflects acquisitions net of cash received for disposal of fixed assets];
- *acquisitions and disposal*;
- *equity dividends paid* [interim and final dividends paid];
- *management of liquid resources* [movement in current asset investments]; and
- *financing* [issue of share capital or issue and redemption of debentures].

FRS 1 also requires two notes to the cash flow statement; a reconciliation of net cash flow to 'net debt' and an analysis of changes in that 'net debt'.

Moving to the international arena, in recent years there has been significant progress on the harmonisation of global accounting standards. IAS 7 requires enterprises to present a cash flow statement as part of their financial statements. The statement is needed as a result of the difference between profits and cash and thus provides the user with a basis for:-

- providing additional information on business activities;
- assessing the current liquidity of a business;
- showing an overview of the major sources of business cash flow;
- estimating future cash flow;
- identifying cash flows generated from trading as opposed to other sources of finance.



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The IASC's objective of IAS 7 is to provide information on changes by cash and cash equivalents and to classify cash flow under three standard activities headings:-

- *operating* [operating profit adjusted for depreciation, profit and or losses on sale of non-current assets, interest paid, working capital changes i.e. inventories, receivables, payables, interest paid, dividends paid and tax paid];
- *investing* [purchases of non-current assets and proceeds on the sale of such assets];
- *financing* [proceeds on the issue of shares and loan notes, redemption of certain shares and loan notes];

and to determine whether the operating activities reveal a positive cash flow, whether the overall activities yield a positive cash flow and the manner in which such activities have been funded.

The main differences between FRS 1 and IAS 7 relate to format issues:-

1. FRS 1 reports changes in cash, whereas IAS 7 reports on cash and cash equivalents.
2. FRS 1 requires cash flows to be analysed and grouped under nine separate headings, whereas IAS 7 requires only three.
3. IAS 7 does not exempt any entities from presenting a cash flow statement, whereas FRS 1 specifies a number of exemptions from its scope.
4. FRS 1 requires 'net debt' disclosures. IAS 7 specifies different disclosure items.

In Germany, the German Accounting Standards Committee (GASC) has issued German Accounting Standard 2 (DRS 2) - Cash Flow Statements. A further two standards apply to Financial Institutions (DRS 2-10) and Insurance Enterprises (DRS 2-20).

A cash flow statement is not required to be included in an individual entity's statutory financial statements. However, following the introduction of KonTraG (Law on Control and Transparency within Enterprises) in 1998, all listed companies are required to include a statement of cash flows in the notes to their consolidated financial statements.



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The requirements of DRS 2 are broadly similar to the requirements of FRS 1, applicable in the UK. The main variations are listed below:-

- i. The statement of cash flows reconciles the movements in cash and cash equivalents, so-called “cash funds”.
- ii. The GASC recommends cash flows to be classified under the headings:-
 - current business
 - investment
 - financing
- iii. The cash flow from current activities can be presented either under the direct or indirect methods. FRS 1 requires the indirect method of presentation.
- iv. The composition of “cash funds” is required to be disclosed in the notes to the financial statements. FRS 1 requires a statement reconciling the movement of cash with the movement in net debt.
- v. Cash flows denominated in foreign currencies are required to be translated at the rates ruling at the date of payment. FRS 1 permits using the average rate or closing rate - whichever is used for the profit and loss accounts.
- vi. Changes in “cash funds” due to the effect of changes in exchange rates on consolidated foreign subsidiaries are required to be disclosed as a separate line of the cash flow statement. Under FRS 1 the effect of exchange rate changes is included in the reconciliation of net debt.
- vii. Major investment and financing transactions without cash flow impact as well as other non-cash transactions are required to be disclosed in the notes to the financial statements. Under FRS 1 material non-cash transactions are only disclosed where necessary to understand the underlying transactions.

In recent years we have seen a greater emphasis on the part of international standard setters to adopt a strategy to achieve a single set of global accounting standards by working towards harmonisation. A review of cash flow statements under FRS 1 (UK), IAS 7 (International) and DRS 2 (Germany) indicates only minor differences between the standards, hence will result in a significant step towards international convergence.