

ACCA Award in Financial Management
(RQF Level 4)

FFM

Foundations in Financial Management

STUDY TEXT

British Library Cataloguing-in-Publication Data

A catalogue record for this book is available from the British Library.

Published by:

Kaplan Publishing UK
Unit 2 The Business Centre
Molly Millars Lane
Wokingham
RG41 2QZ

ISBN: 978-1-78740-386-4

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Printed and bound in Great Britain.

Acknowledgments

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CONTENTS

	<i>Page</i>
Introduction	P.5
Syllabus and study guide	P.7
The examination	P.17
Study skills and revision guidance	P.19
Mathematical tables	P.21
Chapter	
1 Cash and cash flows	1
2 Cash budgets	17
3 Cash management	59
4 Investing surplus funds	79
5 Working capital management	101
6 Managing inventory and payables	125
7 Managing receivables	153
8 Debt collection	193
9 Financial management environment	231
10 The economic environment	245
11 Short- and medium-term finance	257
12 Long-term finance	281
13 Sources of finance for small and medium-sized enterprises	301
14 Capital investment planning and control	313
15 Capital investment appraisal	325
Answers to activities and practice questions	361
Index	405

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INTRODUCTION

This is the new edition of the study text for FFM – *Foundations in Financial Management*, approved by the ACCA and fully updated and revised according to the examiner's comments.

This study text has been written specifically for ACCA Foundation students, and has been reviewed by the ACCA. A clear and comprehensive style, numerous examples and highlighted key terms help you to acquire the information easily. Plenty of activities and self-test questions enable you to practise what you have learnt.

At the end of most of the chapters you will find practice questions. Many of these are exam-style questions and will give you a good idea of the way you will be tested. To give you some more invaluable practice at exam style questions (including many real past-exam questions), you should also buy the Kaplan Exam Kit for FFM.

THE EXAMINATION

Format of the examination

The examination is a two-hour paper.

	<i>Number of marks</i>
Section A: 15 multiple choice questions, worth 2 marks each	30
Section B: 7 written questions worth 5-20 marks each	
Q1 20 marks	20
Q2, 3, 4 & 5 (5 marks each)	20
Q6 & 7 (15 marks each)	30
	—
	100
	—

Sitting the examination

Spend the first few minutes reading the exam paper.

Unless you know exactly how to answer a question, spend some time **planning your answer**. Stick to the question and tailor your answer to what you are asked.

Fully explain all your points but be concise. Set out all workings clearly and neatly, and state briefly what you are doing. Don't write out the question.

If you do not understand what a question is asking, **state your assumptions**. Even if you do not answer precisely in the way the examiner hoped, you should be given some credit, if your assumptions are reasonable.

If you get stuck with a question, leave space in your answer book and return to it later.

Answering the questions

Multiple choice questions: Read the question and try to answer it without referring to the answers. When you have an answer, compare it to the choices given and (hopefully) pick the correct one. If your answer does not match any of the choices given, try to rework your answer. If you cannot get any of the answers provided, do not leave a blank space in your answer sheet. You will not have marks deducted for putting the wrong answer, so always make a guess if you cannot get the correct answer.

Essay questions: Make a quick plan in your answer book and under each main point list all the relevant facts you can think of. Then write out your answer developing each point fully. Your essay should have a clear structure; it should contain a brief introduction, a main section and a conclusion. Be concise. It is better to write a little about a lot of different points than a great deal about one or two points.

Computations: It is essential to include all your workings in your answers. Many computational questions require the use of a standard format: company profit and loss account, statement of financial position and cash flow statement for example. Be sure you know these formats thoroughly before the examination and use the layouts that you see in the answers given in this book and in model answers. If you are asked to comment or make recommendations on a computation, you must do so. There are important marks to be gained here. Even if your computation contains mistakes, you may still gain marks if your reasoning is correct.

Reports, memos and other documents: Some questions ask you to present your answer in the form of a report or a memo or other document. Use the correct format – there could be easy marks to gain here.

Chapter 1

CASH AND CASH FLOWS

Businesses exist to make profit, but they cannot survive without cash. This chapter explains the nature of cash receipts and payments in a business, and considers the importance of cash flow and liquidity. Cash flow is compared with profitability. The elements of cash management are explained, and the relationship between cash management and credit control is introduced.

This chapter covers Syllabus part B1.

CONTENTS

- 1 The nature of cash and cash flows
 - 2 The sources and applications of finance
 - 3 Cash flow and profit
 - 4 Cash accounting and accruals accounting
-

LEARNING OUTCOMES

At the end of this chapter you should be able to:

- Define cash, cash flow and funds
 - Explain the importance of cash flow management and its impact on liquidity and company survival
 - Outline the various sources and applications of finance
 - (i) regular revenue receipts and payments
 - (ii) capital receipts and payments
 - (iii) drawings or dividends and disbursements
 - (iv) exceptional receipts and payments
 - Distinguish between the cash flow patterns of different types of organisations
 - Explain the importance of cash flow for sustainable growth of such organisations
 - Define 'cash accounting' and 'accruals accounting'
 - Explain the difference between cash accounting and accruals accounting
 - Reconcile cash flow to profit.
-

1 THE NATURE OF CASH AND CASH FLOWS

1.1 RELEVANT DEFINITIONS

The first requirement in this syllabus is for you to be able to define cash, cash flows and funds.

Cash can be defined as money, in the form of notes and coins. It is the most liquid of assets and represents the lifeblood for growth and investment. Cash includes:

- coins and notes
- current accounts and short-term deposits
- bank overdrafts and short-term loans
- foreign currency and deposits that can be quickly converted to your currency.

It does not include:

- long-term deposits
- long-term borrowing
- money owed by customers
- inventory (stock).

It is important not to confuse cash with profit. Profit is the difference between the total amount a business earns and all of its costs, usually assessed over a year or other trading period. A business may be able to forecast a good profit for the year, yet still face times when it is strapped for cash.

Cash flow is a term for receipts and payments of cash. Cash flow shows the money flowing into a business from sales, interest payments received, and any borrowings and the amount of money flowing out of a business through paying for wages, rent, interest owing, paying back loans, buying raw materials, tax and so on.

Cash flow can be described as a cycle: a business uses cash to acquire resources. The resources are put to work and goods and services produced. These are then sold to customers, the business then collects and deposits the cash from the sales and so the cycle repeats.

Net cash flow is the difference between the cash received in a period and the cash paid out in the same period

On any single day, or in any week or month, cash receipts can exceed cash payments, in which case the cash flow is positive. Equally, cash payments can exceed cash receipts, and the cash flow is negative. Over time, a business should expect cash receipts to exceed cash payments, or at least that cash payments should not exceed cash receipts.

Funds can be defined as any arrangement that enables goods or services to be bought. It therefore usually means money (i.e. cash or bank balances) or credit (i.e. lending or borrowing). Every transaction that a business makes can be interpreted in terms of a source of funds and use of funds, which must be equal in total.

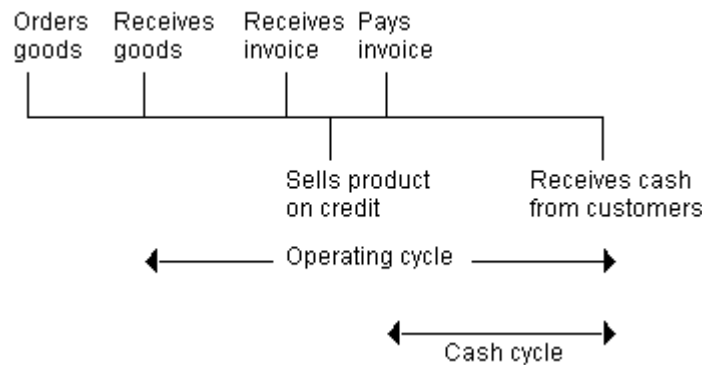
Managing cash in a business is basically similar to the management of cash by an individual. An individual might receive cash every month in the form of a salary and pay out money on a variety of expenses, such as food and drink, travel, rent and so on. Some spending is likely to be on credit (using a credit card, perhaps), just as businesses take credit for most of their purchases, but credit card bills have to be paid eventually. Individuals have to make sure that they have enough cash coming in each month to make all the payments that have to be made. An individual might have a bank overdraft facility, but the bank will not let the overdraft exceed the agreed limit.

Businesses have the same concerns. They can buy on credit, but suppliers eventually have to be paid. They can borrow and negotiate an overdraft facility, but there are limits to borrowing. Consequently, cash has to be managed, to make sure that there is always enough money to keep the business going

1.2 CASH CYCLE AND OPERATING CYCLE

The cash flow cycle, in its simplest form, revolves around the company's trading cycle. The process involves purchasing inventory (stock), converting it to cash or accounts receivable via sales, collecting those accounts receivable, and paying suppliers who extended trade credit.

Cash cycle and operating cycle



The cash flow cycle is the period of time required for an organisation to receive invested funds back in the form of cash. The full cash flow cycle can be divided into two distinct cycles:

- 1 The **operating cycle** – the time period between acquiring inventory from suppliers and the actual cash collection from receivables (debtors) for goods sold.
- 2 The **cash cycle** – the time period between the cash payment for inventory and the cash collection of accounts receivables generated in the sale of the final product.

The cash conversion period measures the amount of time it takes to convert the organisation's product or service into cash inflows. It is calculated by:

- + The number of days that cash is locked up as inventory or work in progress
- + The number of days that cash is locked up in receivables
- Days that cash is free because the business has not paid its bills

2 THE SOURCES AND APPLICATIONS OF FINANCE

2.1 SOURCES AND USES OF CASH

Sources and uses of cash cover three activities in an enterprise:

- 1 **Operating activities** are activities that create revenue or expense in the entity's major line of business. The largest cash inflow from operations is the collection of cash from customers. Operating activities that create cash outflows include payments to suppliers, payments to employees, interest payments, payment of income taxes and other operating cash payments.
- 2 **Investing activities** include lending money and collecting on those loans, buying and selling productive assets that are expected to generate revenues over long periods, and buying and selling securities not classified as cash equivalents. Cash inflows generated by investing activities include sales of long-lived assets such as property, plant and equipment, sales of debt or equity instruments and the collection of loans.
- 3 **Financing activities** include borrowing and repaying money from payables (creditors), obtaining resources from owners and providing both a return on their investment and a return of their investment. The return on investment is provided in the form of dividends.

Sources of cash	Uses of cash
Obtaining finance: <ul style="list-style-type: none"> • Increase in long-term debt • Increase in equity • Increase in current liabilities Selling assets <ul style="list-style-type: none"> • Decrease in current assets • Decrease in fixed assets (non-current assets) 	Paying payables or stockholders: <ul style="list-style-type: none"> • Decrease in long-term debt • Decrease in equity • Decrease in current liabilities Buying assets <ul style="list-style-type: none"> • Increase in current assets • Increase in fixed assets (non-current assets)

Fixed assets (which are also known as non-current assets), as you know, are assets that are used by the business on a continuing basis. Current assets are items which are either cash already or which the business intends to turn into cash. Current liabilities are debts that the business has to pay in the near future – which we take to mean debts due for payment within the next year.

Working capital is the net difference between current assets and current liabilities.

ACTIVITY 1

Working capital is the third different meaning given to the word 'capital' in accounting terms.

Required:

Can you explain the three meanings?

For a suggested answer, see the 'Answers' section at the end of the book.

2.2 MAIN TYPES OF CASH RECEIPTS AND PAYMENTS

The cash receipts for a business come from a variety of sources, and there are various reasons for making cash payments. Cash receipts and payments can be categorised into the following types:

- revenue receipts and payments
- capital receipts and payments
- drawings/dividends and disbursements
- exceptional receipts and payments.

All of these types of cash receipt and payment affect the cash flows of a business, and cash management involves making sure that the total amount of cash received from these sources is always enough to make all the necessary cash payments.

Revenue receipts and payments are cash receipts and payments arising from the normal course of business. Revenue receipts are cash receipts from:

- cash sales, and
- payments by trade receivables.

Revenue payments are payments in the normal course of business, and include payments:

- to trade payables
- to employees for salaries and wages (and to the tax authorities for income tax deductions)
- for business expenses such as office rental payments, telephone bills, payments out of petty cash, and so on.

Capital receipts are receipts of long-term funds or cash from the sale of non-current assets or long-term investments. The owners of a business put new capital into the business in the form of new cash. For example, the shareholders in a company might agree to put more cash into the business by subscribing for a new issue of shares. Similarly, a sole trader might decide to put some extra money into the business by transferring cash from his personal bank account to his business bank account.

Capital payments are payments for capital expenditure, such as the purchase of new non-current assets (equipment, motor vehicles and so on).

Occasionally, a business might raise new cash by obtaining a long-term loan. A loan from a bank is a liability, but long-term (non-current) liabilities can be thought of as a 'capital receipt'. Similarly, the repayment of a loan might be thought of as a 'capital payment'.

Drawings/dividends and disbursements

When a business makes profits, it usually pays out some of those profits to its owners.

- Payments out of profits to a sole trader or partners in a partnership are known as drawings.
- Payments out of profits to the shareholders of a company are known as dividends.

Businesses can pay drawings or dividends whenever they want to. However, many companies pay dividends to shareholders twice each year. One dividend payment is an interim dividend, paid in the middle of the year when the profits for the first six months are known. The second dividend payment is a final dividend, which is paid after the end of the year when the profits for the full year are known.

In practice, this means that during any financial year, a company might pay out in dividends to its shareholders:

- a final dividend for the previous financial year, and
- an interim dividend for the current financial year.

The term 'disbursement' simply means a payment. The term could be used, however, to mean payments of:

- interest on loans and overdrafts, and on other debts for which interest is payable (such as loan stock or 'bonds' in the case of companies)
- income tax payable by a company out of its profits (corporation tax in the UK).

EXCEPTIONAL RECEIPTS AND PAYMENTS

The foregoing are all relatively routine transactions. They are known and they can be planned for. There is always the possibility that there will be a significant movement because of an unusual or 'exceptional' transaction that does not fall into any of the categories described above. An example would be the costs of closing down part of a business.

2.3 CASH FLOW PATTERNS IN DIFFERENT BUSINESSES

The 'dynamics' or patterns of revenue receipts and payments vary greatly between different types of business. Many businesses have regular expenditure patterns, such as constant monthly salary costs and regular monthly accommodation costs. However, patterns of cash receipts vary enormously, as the following examples might suggest.

- A retail business with a chain of shops or stores buys goods for resale, often obtaining credit of 30 to 60 days from suppliers. It might hope to re-sell many of the items fairly quickly, typically for cash. As we have already noted, many retail businesses are therefore able to receive cash from selling their goods even before they have had to pay their suppliers. Cash receipts are also daily, or at least every day that the shops are open.

- A hat manufacturer has a seasonal business, with most sales in the spring and early summer. Its sales are likely to be on credit to retailers and other distributors, on 30 to 60 days' credit. It produces hats continually throughout the year, so has fairly constant monthly cash expenditures.
- A large contracting business might have to spend a lot of cash in bidding to win a large construction contract. Some companies, for example, have spent several years in bidding for government contracts to build schools, hospitals or roads. If they win a new contract, they are likely to have to spend heavily on hiring labour and buying or renting equipment. Cash receipts from the customer are likely to be in the form of progress payments, which are usually occasional large amounts.
- A training college or university is likely to receive most of its income at the start of its courses, mainly at the beginning of the academic year. Its costs and cash expenditures occur over the duration of the course. It should therefore expect a large cash surplus at the start of the academic year, which then gradually reduces as the year progresses.

You might be aware of other businesses with different cash flow patterns to these.

3 CASH FLOW AND PROFIT

For a business to survive, over the longer term it has to be profitable. In the short term, however, cash flow is more important than profit. If a business cannot make an essential payment, it could be faced with insolvency and payables could take action to recover the money owing to them. In the short term:

- a business can make a loss but still have enough cash to survive, receiving more cash than it pays
- a business can be profitable but run out of cash, spending more cash than it receives.

In the short term, profits and cash flow are different. There are several reasons for this.

- Some items of cash spending and cash receipt do not affect profits at all. In particular capital receipts and capital payments do not affect profits. A business could earn a profit but spend large sums of money on capital expenditure, so that it makes a profit but has a negative cash flow.
- Profits are calculated after deducting depreciation charges on non-current assets. Depreciation is a notional charge, and does not affect cash flow at all. It is an accounting device for spreading the cost of a non-current asset over its useful life.
- Cash flow is affected by the need to invest in operational working capital. Operational working capital is defined as the working capital a business needs to carry on its day-to-day business operations. It consists of its inventory (stock) plus its trade receivables minus its trade payables.

Investing in working capital affects cash flow, and when the total amount of working capital of a business changes, the profits earned in the period will differ from the operational cash flows. It might not seem obvious why this should be the case.

- **Inventory (stock).** A business buys raw materials or supplies and uses these to manufacture goods or provide services. Materials and supplies are bought before goods can be produced or services can be provided, which means that a business has to pay for its inventory before it earns anything from sales.
- **Receivables (debtors).** When businesses sell goods or services on credit, they make a profit when the sale occurs, but they do not get any cash receipts until the customer pays. A business therefore incurs the costs of making a sale, and spends cash in advance of receiving the cash income.
- **Payables (creditors).** On the other hand, if a business buys goods and services on credit, it benefits by not having to pay for them until sometime after they have been received.

We can compare the gross profit from trading with the operating cash flows from trading in a company that buys and resells goods.

The statement of profit or loss reports the total value of sales and the cost of goods sold in a year and shows:

Sales revenue – Cost of sales = Profit

However, if goods are sold on credit the cash receipts will differ from the value of sales, as receivables will pay after the year-end. The cost of goods sold will also differ as some goods are purchased on credit and some may remain in inventory at the year-end.

The operational cash flow is reported as cash in (Sales + Opening receivables – Closing receivables) – Cash out (Purchases + Opening payables – Closing payables).

ACTIVITY 2

Calculate the profit and the operational cash flow resulting from the year's trading figures for ABC given below:

Sales revenue	\$240,000
Cost of sales	\$204,000
Opening inventory	\$14,400
Payables at start of year	\$13,200
Receivables at start of year	\$18,000
Closing inventory	\$25,200
Payables at end of year	\$16,800
Receivables at end of year	\$28,800

For a suggested answer, see the 'Answers' section at the end of the book.

The following example illustrates how the profits of a business and its cash flows in the same period are different because of working capital.

Example

In September 20X4 Peter entered into a contract with QAZ Limited, a manufacturer of electrical equipment. Under the terms of the contract, Peter will repair any electrical items failing within their warranty period that are returned to QAZ for repair by its dissatisfied customers. He will invoice QAZ as follows:

Labour	\$25 per hour
Materials	Cost + 40%

Peter will receive payment from QAZ against a sales invoice, sent at the end of each month, with payment to be made 60 days after the invoice date.

Peter pays wages of \$10 per hour, paying his employees at the end of each week. Payments to suppliers for materials are made one month after receipt from the supplier.

Let's suppose that Peter opens a separate bank account for receipts and payments for this contract with QAZ.

The following transaction details relate to October, November and December 20X4:

	<i>October</i>	<i>November</i>	<i>December</i>
	\$	\$	\$
Wages cost	400	500	700
Material cost	600	800	1,000
Sales invoiced	1,840	2,370	3,150

The contract is profitable, because the sales exceed the combined cost of wages and materials.

	<i>October</i>	<i>November</i>	<i>December</i>
	\$	\$	\$
Sales	1,840	2,370	3,150
Costs:			
Wages cost	400	500	700
Material cost	600	800	1,000
Total costs	<u>1,000</u>	<u>1,300</u>	<u>1,700</u>
Profit	840	1,070	1,450

However, Peter's cash flows in the first few months of the contract are a cause for concern.

	<i>October</i>	<i>November</i>	<i>December</i>
	\$	\$	\$
Receipts:			
Paid sales invoices	0	0	1,840
Payments			
Wages	400	500	700
Materials	0	600	800
Total payments	<u>400</u>	<u>1,100</u>	<u>1,500</u>
Cash surplus/(deficit) for the month	(400)	(1,100)	340
Opening cash balance	0	(400)	(1,500)
Closing cash balance	(400)	(1,500)	(1,160)

Peter has to be able to fund the wage costs and material costs for the first two months before any money is received from QAZ for the work done. He will therefore have to find \$1,500 in cash, or borrow to meet these cash requirements, even though the contract is profitable from the first month onwards.

Every month, the difference between profit and cash flow forces Peter to invest more in working capital. There is no inventory, and working capital is therefore total receivables minus total payables.

	<i>End of October</i>	<i>End of November</i>	<i>End of December</i>
	\$	\$	\$
Receivables			
Unpaid sales in October	1,840	1,840	–
Unpaid sales in November	–	2,370	2,370
Unpaid sales in December	–	–	3,150
	<hr/>	<hr/>	<hr/>
Total receivables	1,840	4,210	5,520
Payables for materials	600	800	1,000
	<hr/>	<hr/>	<hr/>
Working capital	1,240	3,410	4,520
	<hr/>	<hr/>	<hr/>
Increase/(decrease) in working capital in the month	1,240	2,170	1,110

So profits and cash flows each month can be reconciled by adjusting for the working capital movement as follows:

Profit in the month	840	1,070	1,450
Increase/(decrease) in working capital in the month	1,240	2,170	1,110
	<hr/>	<hr/>	<hr/>
Net cash flow in the month	(400)	(1,100)	340
	<hr/>	<hr/>	<hr/>

We could do this calculation for any company, although it would become very much more complicated if the company had more than one contract in progress or had a more complicated set of transactions to analyse.

3.1 CASH FLOW AND BUSINESS SURVIVAL

In the short run, a loss-making business can survive, provided that it has enough cash or access to new borrowings. A profitable business might not survive if it has negative cash flows, unless it has enough cash in the bank to cover the deficit or unless it has access to new borrowings. In the past, there have been many examples of apparently successful businesses collapsing because they ran out of cash.

3.2 CASH FLOW AND BUSINESS GROWTH

Cash flow is the lifeblood of a business. Cash is absolutely critical in the growth and wellbeing of a business.

Cash flow analysis shows whether the enterprise's daily operations generate enough cash to meet their business obligations. It also indicates how major cash outflows relate to major cash inflows. Early identification of cash-related problems will facilitate better control of cash flows and will allow adequate time to plan and prepare for the sustained growth of the business.

A successful business that is trying to grow can also run into cash flow difficulties. As it increases its sales, a business might have to take on more employees, and buy more equipment and other non-current assets. It might have to buy larger quantities of inventory, and give its customers longer credit periods. To avoid cash flow problems, a business should therefore plan its sales growth, and make sure that it will have the liquidity (cash or new debt) to finance its growth.

3.3 LIQUIDITY

Liquid assets consist of both cash and items that could or will be converted into cash within a short time, with little or no loss. They include some investments, for example:

- deposits with banks or building societies where a minimum notice period for withdrawal is required.
- investments in government securities, which in the UK are called gilt-edged stocks (or 'gilts').

Other liquid assets are trade receivables and, possibly, inventory.

- Trade receivables should be expected to pay what they owe within a fairly short time, so receivables are often considered a liquid asset for a business.
- In some businesses, such as retailing, inventory will be used or re-sold within a short time, to create sales for the business and cash income. Inventory is less liquid than receivables.

A business has liquidity if it has access to enough liquid assets to meet its essential payment obligations when they fall due. This means that a business is extremely liquid if it has a large amount of cash, plus investments in gilts and funds in notice accounts with a building society, plus a large amount of trade receivables and inventory.

Liquidity is also boosted if a business has an unused overdraft facility, so that it could go into overdraft with its bank if it needed to.

A business that has good liquidity is unlikely to have serious cash flow problems. For all businesses, it is important to make revenue payments when they fall due. Trade payables and employees should all be paid on time. When a liquid business has to make a cash payment, it should be able to obtain the money from somewhere to do it. Normally, the cash to pay suppliers and employees comes from the cash received from trade receivables.

The liquidity of a business, particularly its operational activities, is therefore related to its working capital, and in particular its inventory, receivables and short-term payables.

Conclusions so far

- Cash flow and profit are not the same.
- One reason for the difference is changes in operational working capital. Operational working capital consists of inventory plus trade receivables minus trade payables.
- To survive in the short term a business must have liquidity. Liquidity means cash or ready access to sources of cash, such as new borrowing.
- A business that has reached its borrowing limits needs to have positive cash flow to survive.
- Cash flow management should ensure survival and promote sustainable growth in the business.

ACTIVITY 3

What separates cash from profits? Explain why lots of sales might not mean lots of cash.

For a suggested answer, see the 'Answers' section at the end of the book.

3.4 RECONCILING CASH AND PROFITS

It is often useful to reconcile a firm's profit figure to its cash inflow from operating activities. The main reconciling items are:

- non-cash items that affect profit, such as depreciation and profits/losses on disposals of assets.
- movements in inventories, payables and receivables.

Therefore, the standard layout for a reconciliation would be:

Operating profit	X
Add: Depreciation charges	X
Add: Loss on sale of non-current assets (or deduct profit on sale)	X
Add: Decrease in inventory (or deduct increase)	X
Add: Decrease in trade receivables (or deduct increase)	X
Add: Increase in trade payables (or deduct decrease)	X
	—
Net cash inflow from operating activities	X
	—

Example

Wild Co made an operating profit of \$27,000 last year. Depreciation was \$6,000 in the year, and assets with a book value of \$40,000 were sold for \$35,000. Extracts from the statement of financial position at the start and the end of the year show the following:

	<i>Start of year</i>	<i>End of year</i>
Inventory	\$10,000	\$14,500
Receivables	\$21,000	\$20,000
Payables	\$13,100	\$14,050

The net cash inflow for the year can be found from the following reconciliation:

	\$
Operating profit	27,000
Add: Depreciation charges	6,000
Add: Loss on sale of non-current assets	5,000
Deduct: increase in inventory	(4,500)
Add: Decrease in trade receivables	1,000
Add: Increase in trade payables	950
	—
Net cash inflow from operating activities	35,450
	—

ACTIVITY 4

Muchacho Co generated \$44,500 of cash from its operating activities last year.

Extracts from the statement of financial position at the start and the end of the year show the following:

	<i>Start of year</i>	<i>End of year</i>
Inventory	\$17,000	\$12,500
Receivables	\$34,000	\$29,000
Payables	\$36,000	\$32,500

Depreciation was \$25,000 in the year, and assets with a book value of \$10,000 were sold for \$25,000.

Required:

Calculate the profit made by Muchacho last year.

For a suggested answer, see the 'Answers' section at the end of the book.

4 CASH ACCOUNTING AND ACCRUALS ACCOUNTING

Profit does not necessarily equal cash. Cash flow includes cash items other than those associated with trading, for example receipt of shareholders' capital, and expenditure on non-current assets. Also, trading or operational transactions are not all converted into cash within the accounting period; they may be held as accounts payable, inventory and accounts receivable, until a subsequent accounting period.

Since businesses need liquidity and positive cash flows to survive, it might be asked why it is usual to focus on profitability rather than cash flow. Traditionally, business performance has been measured by profit using a system of accounting known as **accruals accounting**. In a system of accruals accounting, revenues and costs are reported in the period where the sale occurs, even if the cash flows for the sale and costs of sale occur in different periods, whereas a system of cash accounting records cash payments and cash receipts as they occur within an accounting period.

Definition The **accruals concept** in accounting has been defined as follows. 'Revenues and costs are accrued (that is, recognised as they are earned or incurred, not as money is received or paid), matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the statement of profit or loss of the period to which they relate.'

Accruals accounting is recognised by law, and businesses are required to use it to measure their profitability for the purpose of external financial reporting.

Definition **Cash accounting** is an alternative to accruals accounting. It is a system of accounting for costs and income on the basis of cash payments and cash receipts.

It is an accounting method where receipts are recorded during the period they are received, and the expenses in the period in which they are actually paid. Basically, when the cash is received for a sale, it is recorded in the accounting books as a sale. This is in contrast with accruals accounting, where revenue and expenses are recorded when they are earned or incurred.

However, cash accounting is not generally accepted as good accounting practice because businesses enter into transactions that are legally enforceable prior to the exchange of cash, but the use of cash accounting does not reflect any transactions which have taken place but are not yet paid for.

For example, a business has received \$50,000 in cash sales during the year. It has spent \$40,000 in cash on expenses. It has receivables owing \$10,000 at 30 June. It owes suppliers \$7,000 for goods and services received. On a cash accounting basis, the net profit of the business would be \$10,000 (i.e. \$50,000 less \$40,000). On an accruals accounting basis, the net profit would be \$13,000 (i.e. \$50,000 + \$10,000 – \$40,000 – \$37,000).

Although cash accounting is not used for measuring profitability, cash flow management is a vital aspect of business. Businesses should:

- forecast what their cash flows are likely to be in the future, so that they can take measures to ensure that they will have enough cash/liquidity. Cash flow forecasts might be prepared as cash budgets
- monitor actual cash flows, to make sure that these are in line with expectation (for example, by comparing them with the cash budget) and that the business still has enough cash to meet its requirements.

4.1 ACCRUALS ACCOUNTING

The accruals concept, or matching concept, requires that revenue and costs are:

- recognised as they are earned or incurred
- 'matched' with one another in the period to which they relate
- dealt with in the statement of profit or loss of the period to which they relate, irrespective of the period of receipt or payment

Accruals – it may be that an expense has been incurred within an accounting period, for which an invoice may or may not have been received. Such charges must be matched to the accounting period to which they relate and therefore an estimate of the cost (an accrual) must be made and included as an accounting adjustment in the accounts for that period.

Prepayment – it may be that an expense has been incurred within an accounting period that related to future period(s). As with accruals, these costs are not necessarily related to sales and cannot be matched with sales. Such charges must also be matched to the period to which they relate and therefore the proportion of the charges that relate to future periods (a prepayment) must be calculated and included as an adjustment in the accounts for that period.

Revenues are included in the period in which the sale takes place rather than when cash is received. It is therefore appropriate to 'match' the costs or expenses incurred in generating this income in the same period. The operating profit determined in this way is supposed to indicate how efficiently the resources of the business have been utilised.

For example, cost of goods sold is included in the statement of profit or loss in the same year that the sale of the goods generates income.

	\$
Sale made 28 December 20X8	5,000
Money received from customer 1 February 20X9	5,000
Cost of goods sold	3,300

For the year ended 31 December 20X8 the statement of profit or loss extract would be as follows:

	\$
Sales	5,000
Cost of sales	(3,300)

Although the cash is received the year after the actual sale took place (20X9), it is recognised in the statement of profit or loss for the year ended 31 December 20X8. In accordance with the accruals concept the cost of those goods must also be included in that year.

Although in the main the accruals concept is easy to apply, there are circumstances which cause problems, the most common being the purchase of non-current assets.

A non-current asset will incur a cost in one year, the year of purchase, but will generate income over many years. The solution is to spread the cost over the period the asset will generate income, so matching income and expense. The method used to achieve this is depreciation.

CONCLUSION

This chapter provided an introduction to cash and credit management. We also discussed the types of cash flow and their different patterns. Some cash flows will be regular, but others will be less frequent, or unpredictable, and these can be a major influence on an enterprise's cash position.

Cash management is absolutely crucial to the smooth running of the company, and possibly even to its survival. A key to successful cash management is accurate cash forecasting and cash budgeting. This is described in the next chapter.

KEY TERMS

Cash flow – receipts and payments of cash.

Revenue receipts – cash receipts from cash sales and payments by credit customers.

Revenue payments – payments for operating expenses incurred in the normal course of business (payments to suppliers, employees and so on).

Capital receipts – receipts of cash as new long-term finance or from the sale of non-current assets or long-term investments.

Capital payments – cash payments for the purchase of fixed assets and other long-term investments.

Liquid assets – cash and other assets that can be cashed easily (short-term investments) or will turn into cash fairly soon (e.g. receivables).

Liquidity – liquid assets and access to new sources of short-term finance (e.g. overdraft facility).

SELF-TEST QUESTIONS

	<i>Paragraph</i>
1 Define cash.	1.1
2 Define cash flow.	1.1
3 What are the main types of cash flow for a business?	2.2
4 State some of the reasons why the profit in a period is different from the net cash flow.	3
5 What are liquid assets?	3.3
6 Define liquidity.	3.3
7 Explain 'cash accounting'.	4
8 Explain 'accruals accounting'.	4.1