

Undergraduate Diploma in Business Administration

Module 03 Financial Analysis MQF Level 5 (8 ECTS)

Lecture 4

Phase 1: The Accounting Cycle & Building the Statements



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CASH FLOW

Core Principle: A business can be profitable and still run out of cash.



Video

https://www.youtube.com/watch?v=Ev_EvBbTfe4&t=39s



What is Cash Flow?

Definition

- The movement of money INTO and OUT OF a business over a specific period. We monitor how much cash is moving in and out of the business.
- Core question: Does the business have enough cash to pay its bills TODAY?

Cash Inflows

- Sales collected from customers | Loan proceeds received | Asset sales | Investment income

Cash Outflows

- Payments to suppliers | Wages & salaries | Loan repayments | Tax | Equipment

Key rule: Cash flow is not the same as profit. A business records profit when it earns revenue and incurs an expense — but cash moves only when money is actually received or paid.



Example

Borg Ltd made a Net Profit of €10,000 if customers haven't paid yet that cash isn't actually in the bank that's why **cash flow is such a critical indicator of financial health.**

Cash vs Profit — The Critical Distinction

Sunrise Bakery Example

- Sells 10,000 of cakes on 60-day credit — income statement shows 3,000 profit
- BUT: zero cash received yet — must still pay flour supplier 2,000 this week

Key Scenarios

- Sales on credit not yet collected: Profit +10,000 | Cash unchanged
- Equipment bought for cash: Profit unchanged | Cash -50,000
- Bank loan received: Profit unchanged | Cash +30,000

A business can be highly profitable and STILL run out of cash — the most important lesson



Accrual vs Cash Accounting

Accrual Accounting (used in financial statements)

- Revenue recognised when EARNED (not when cash is received)
- Expenses recognised when INCURRED (not when cash is paid)

Cash Accounting

- Revenue and expenses only recorded when cash ACTUALLY changes hands

The Bridge — The Cash Flow Statement

- The CFS reconciles accrual-based profit back to actual cash movements
- Depreciation: non-cash expense — reduces profit but NO cash leaves the business

This is why depreciation is ADDED BACK when preparing the indirect method CFS



Three Types of Cash Flows

1. Operating Activities

- Day-to-day core business: cash from customers, wages paid, raw materials, tax paid
- MOST IMPORTANT section — a healthy business must consistently generate positive OCF

2. Investing Activities

- Long-term assets: purchase of machinery, sale of buildings, acquisition of subsidiaries
- Typically NEGATIVE in a growing business — investing in the future is a good sign

3. Financing Activities

- How the business is funded: shares issued, bank loans, dividends, debt repayments



The Cash Flow Cycle

The Operating Cycle

- Cash > Purchase raw materials > Produce goods > Hold as inventory > Sell on credit > Accounts receivable > Collect cash > Back to Cash

The Problem

- There is ALWAYS a time lag between spending cash and receiving it back. Fast-growing profitable businesses often face cash crises because of this lag

Cash Conversion Cycle

- $CCC = \text{Days Inventory Outstanding} + \text{Days Sales Outstanding} - \text{Days Payable Outstanding}$
- $\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$

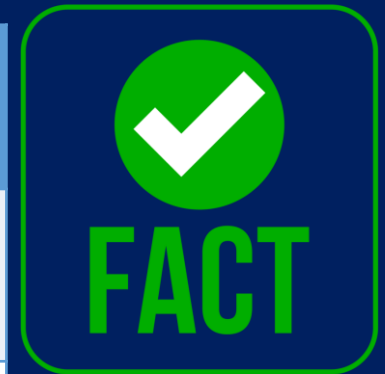
Example: A manufacturer buys materials on Day 1 (cash out), takes 30 days to produce goods, sells on Day 30 but on 60-day credit terms, so collects cash on Day 90. Meanwhile, it must pay wages every two weeks. This is a 90-day cash gap.



Common Cash Flow Misconceptions

Myth vs Reality

Myth	Reality
"We made a profit so we must have cash"	Profit and cash move independently
"Depreciation costs us money each year"	Depreciation is non-cash — the cash left when the asset was bought
"Taking out a loan is income"	Loans are financing inflows, never revenue
"Paying for equipment reduces our profit"	Capital expenditure hits the balance sheet, not profit (only depreciation hits profit)





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Structure of the Cash Flow Statement

The Three-Part Formula

The Cash Flow Statement (CFS) is one of the three core financial statements, alongside the Income Statement and the Balance Sheet. It reconciles the opening and closing cash balance:

Opening cash balance
+ Net cash from OPERATING activities
+ Net cash from INVESTING activities
+ Net cash from FINANCING activities
= Closing cash balance



Structure of the Cash Flow Statement

The Golden Rule

Closing cash balance **MUST** equal cash & cash equivalents on the Balance Sheet.

The CFS is the essential bridge between the Income Statement and the Balance Sheet



Operating Activities — The Indirect Method

Two methods exist to present operating cash flows:

The Indirect Method (most common in practice)

Start with Net Profit, then adjust:

- + Depreciation & amortisation (add back — non-cash expense)
- + Increase in trade payables (cash not yet paid — add back)
- - Increase in trade receivables (cash not yet received — deduct)
- - Increase in inventory (cash tied up in stock — deduct)



Operating Activities — The Indirect Method

Working Rule

Increase in a CURRENT ASSET = USE of cash (deduct)

Increase in a CURRENT LIABILITY = SOURCE of cash (add
back)

*Used by approximately 95% of companies — easier to prepare from accounting
records*



Indirect Method — Worked Example

Calculating Net Cash from Operating Activities

Net profit	80,000
Add: Depreciation	15,000
Less: Increase in receivables	(12,000)
Less: Increase in inventory	(8,000)
Add: Increase in payables	5,000

Net cash from operating activities	80,000

Both figures equal 80,000 here — coincidence for illustration; in practice OCF and profit will differ

Direct Method — Worked Example

Lists actual cash receipts and cash payments:

Cash received from customers	350,000
Cash paid to suppliers	(180,000)
Cash paid to suppliers	(70,000)
Tax Paid	(20,000)

Net cash from operating activities	80,000

Both methods produce the same result. The indirect method is far more common in practice because the underlying data is easier to extract from accounting records.





TechLaunch Ltd



SteadyServices Corp

Why managers analyse these

- If you look at Example 1, a manager might worry about Liquidity. If they keep buying inventory and customers don't pay faster, they might run out of cash to pay wages, despite being "profitable."

Summary of Rules used above:

1. Add back Depreciation (it didn't cost actual cash).
2. Subtract increases in Assets (like Inventory/Receivables)—that's cash "stuck" in the business.
3. Add increases in Liabilities (like Loans/Payables)—that's cash you've "kept" or borrowed.



Intensive class Work

Bayview Trading Ltd – Year ended 31 December 2025

1. Prepare the Statement of Profit or Loss (Income Statement) for Bayview Trading Ltd for the year ended 31 December 2025.
2. Prepare the Statement of Financial Position as at 31 December 2025.
3. Prepare the Statement of Cash Flows for the year ended 31 December 2025, using the indirect method.





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