PART I

Introduction to accounting on a cash flow and accrual accounting basis

CHAPTER 1

Accounting and reporting on a cash flow basis

1.1 Introduction

Accountants are communicators. Accountancy is the art of communicating financial information about a business entity to users such as shareholders and managers. The communication is generally in the form of financial statements that show in money terms the economic resources under the control of the management. The art lies in selecting the information that is relevant to the user and is reliable.

Shareholders require periodic information that the managers are accounting properly for the resources under their control. This information helps the shareholders to evaluate the performance of the managers. The performance measured by the accountant shows the extent to which the economic resources of the business have grown or diminished during the year.

The shareholders also require information to **predict future performance**. At present companies are not required to publish forecast financial statements on a regular basis and the shareholders use the report of past performance when making their predictions.

Managers require information in order to control the business and make investment decisions.

Objectives

By the end of this chapter, you should be able to:

- explain the extent to which cash flow accounting satisfies the information needs of shareholders and managers;
- prepare a cash budget and operating statement of cash flows;
- explain the characteristics that make cash flow data a reliable and fair representation;
- critically discuss the use of cash flow accounting for predicting future dividends.

1.2 Shareholders

Shareholders are external users. As such, they are unable to obtain access to the same amount of detailed historical information as the managers, e.g. total administration costs are disclosed in the published profit and loss account, but not an analysis to show how the figure is made up. Shareholders are also unable to obtain associated information, e.g. budgeted sales and costs. Even though the shareholders own a company, their entitlement to information is restricted.

The information to which shareholders are entitled is restricted to that specified by statute, e.g. the Companies Acts, or by professional regulation, e.g. Financial Reporting Standards, or by market regulations, e.g. listing requirements. This means that there may be a tension between the **amount** of information that a shareholder would like to receive and the amount that the directors are prepared to provide. For example, shareholders might consider that forecasts of future cash flows would be helpful in predicting future dividends, but the directors might be concerned that such forecasts could help competitors or make directors open to criticism if forecasts are not met. As a result, this information is not disclosed.

There may also be a tension between the **quality** of information that shareholders would like to receive and that which directors are prepared to provide. For example, the shareholders might consider that judgements made by the directors in the valuation of long-term contracts should be fully explained, whereas the directors might prefer not to reveal this information given the high risk of error that often attaches to such estimates. In practice, companies tend to compromise: they do not reveal the judgements to the shareholders, but maintain confidence by relying on the auditor to give a clean audit report.

The financial reports presented to the shareholders are also used by other parties such as lenders and trade creditors, and they have come to be regarded as general-purpose reports. However, it may be difficult or impossible to satisfy the needs of all users. For example, users may have different timescales – shareholders may be interested in the long-term trend of earnings over three years, whereas creditors may be interested in the likelihood of receiving cash within the next three months.

The information needs of the shareholders are regarded as the primary concern. The government perceives shareholders to be important because they provide companies with their economic resources. It is shareholders' needs that take priority in deciding on the nature and detailed content of the general-purpose reports.[1]

1.3 What skills does an accountant require in respect of external reports?

For external reporting purposes the accountant has a twofold obligation:

- an obligation to ensure that the financial statements comply with statutory, professional and listing requirements; this requires the accountant to possess **technical expertise**;
- an obligation to ensure that the financial statements present the substance of the commercial transactions the company has entered into; this requires the accountant to have **commercial awareness**.

1.4 Managers

Managers are internal users. As such, they have access to detailed financial statements showing the current results, the extent to which these vary from the budgeted results and the future budgeted results. Other examples of internal users are sole traders, partners and, in a company context, directors and managers.

There is no statutory restriction on the amount of information that an internal user may receive; the only restriction would be that imposed by the company's own policy. Frequently, companies operate a 'need to know' policy and only the directors see all the financial statements; employees, for example, would be most unlikely to receive information that would assist them in claiming a salary increase – unless, of course, it happened to be a time of

recession, when information would be more freely provided by management as a means of containing claims for an increase.

1.5 What skills does an accountant require in respect of internal reports?

For the internal user, the accountant is able to tailor his or her reports. The accountant is required to produce financial statements that are specifically relevant to the user requesting them.

The accountant needs to be skilled in identifying the information that is needed and conveying its implication and meaning to the user. The user needs to be confident that the accountant understands the user's information needs and will satisfy them in a language that is understandable. The accountant must be a skilled communicator who is able to instil confidence in the user that the information is:

- relevant to the user's needs;
- measured objectively;
- presented within a timescale that permits decisions to be made with appropriate information;
- verifiable, in that it can be confirmed that the report represents the transactions that have taken place;
- reliable, in that it is as free from bias as is possible;
- a complete picture of material items;
- a fair representation of the business transactions and events that have occurred or are being planned.

The accountant is a trained reporter of financial information. Just as for external reporting, the accountant needs commercial awareness. It is important, therefore, that he or she should not operate in isolation.

1.5.1 Accountants' reporting role

The accountant's role is to ensure that the information provided is useful for making decisions. For external users, the accountant achieves this by providing a general-purpose financial statement that complies with statute and is reliable. For internal users, this is done by interfacing with the user and establishing exactly what financial information is relevant to the decision that is to be made.

We now consider the steps required to provide relevant information for internal users.

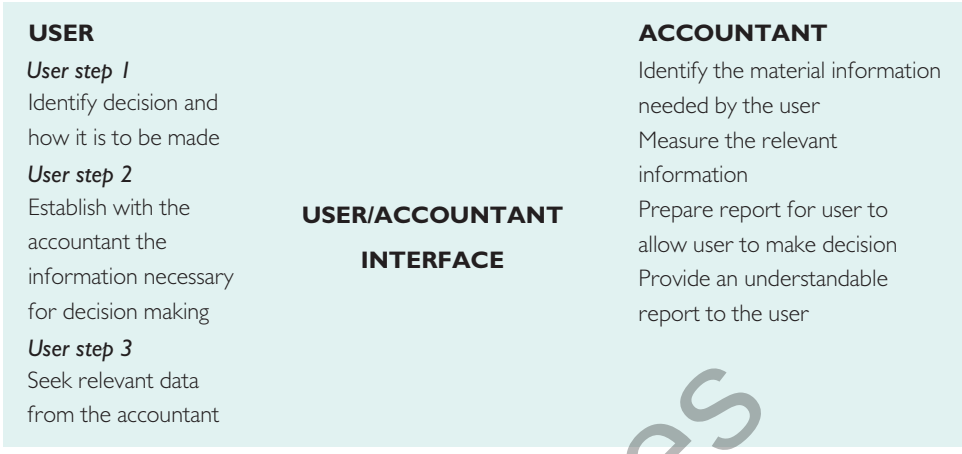
1.6 Procedural steps when reporting to internal users

A number of user steps and accounting action steps can be identified within a financial decision model. These are shown in Figure 1.1.

Note that, although we refer to an accountant/user interface, this is not a single occurrence because the user and accountant interface at each of the user decision steps.

At **step 1,** the accountant attempts to ensure that the decision is based on the appropriate appraisal methodology. However, the accountant is providing a service to a user and, while the accountant may give guidance, the final decision about methodology rests with the user.

Figure 1.1 General financial decision model to illustrate the user/accountant interface



At **step 2**, the accountant needs to establish the information necessary to support the decision that is to be made.

At **step 3**, the accountant needs to ensure that the user **understands** the full impact and financial implications of the accountant's report, taking into account the user's level of understanding and prior knowledge. This may be overlooked by the accountant, who feels that the task has been completed when the written report has been typed.

It is important to remember in following the model that the accountant is attempting to satisfy the information needs of the individual user rather than those of a 'user group'. It is tempting to divide users into groups with apparently common information needs, without recognising that a group contains individual users with different information needs. We return to this later in the chapter, but for the moment we continue by studying a situation where the directors of a company are considering a proposed capital investment project.

Let us assume that there are three companies in the retail industry: Retail A Ltd, Retail B Ltd and Retail C Ltd. The directors of each company are considering the purchase of a warehouse. We could assume initially that, because the companies are operating in the same industry and are faced with the same investment decision, they have identical information needs. However, enquiry might establish that the directors of each company have a completely different attitude to, or perception of, the primary business objective.

For example, it might be established that Retail A Ltd is a large company and under the Fisher–Hirshleifer separation theory the directors seek to maximise profits for the benefit of the equity investors; Retail B Ltd is a medium-sized company in which the directors seek to obtain a satisfactory return for the equity shareholders; and Retail C Ltd is a smaller company in which the directors seek to achieve a satisfactory return for a wider range of stakeholders, including, perhaps, the employees as well as the equity shareholders.

The accountant needs to be aware that these differences may have a significant effect on the information required. Let us consider this diagrammatically in the situation where a capital investment decision is to be made, referring particularly to user step 2: 'Establish with the accountant the information necessary for decision making'.

Figure 1.2 Impact of different user attitudes on the information needed in relation to a capital investment proposal

	USER A Directors of Retail A Ltd	**USER B** Directors of Retail B Ltd	**USER C** Directors of Retail C Ltd
User attitude	PROFIT MAXIMISER for SHAREHOLDERS	PROFIT SATISFICER for SHAREHOLDERS	PROFIT SATISFICER for SHAREHOLDERS/ STAFF
Relevant data to measure	CASH FLOWS	CASH FLOWS	CASH FLOWS
Appraisal method (decided on by user)	IRR	NPV	NPV
Appraisal criterion (decided on by user)	HIGHEST IRR	NPV but only if positive	NPV possibly even if neagtive

We can see from Figure 1.2 that the accountant has identified that:

- the relevant financial data are the same for each of the users, i.e. cash flows; but
- the appraisal methods selected, i.e. internal rate of return (IRR) and net present value (NPV), are different; and
- the appraisal criteria employed by each user, i.e. higher IRR and NPV, are different.

In practice, the user is likely to use more than one appraisal method, as each has advantages and disadvantages. However, we can see that, even when dealing with a single group of apparently homogeneous users, the accountant has first to identify the information needs of the particular user. Only then is the accountant able to identify the relevant financial data and the appropriate report. It is the user's needs that are predominant.

If the accountant's view of the appropriate appraisal method or criterion differs from the user's view, the accountant might decide to report from both views. This approach affords the opportunity to improve the user's understanding and encourages good practice.

The diagrams can be combined (Figure 1.3) to illustrate the complete process. The user is assumed to be Retail A Ltd, a company that has directors who are profit maximisers.

The accountant is reactive when reporting to an internal user. We observe this characteristic in the O'Reilly example set out in Section 1.8. Because the cash flows are identified as relevant to the user, it is these flows that the accountant will record, measure and appraise.

The accountant can also be proactive, by giving the user advice and guidance in areas where the accountant has specific expertise, such as the appraisal method that is most appropriate to the circumstances.

Figure 1.3 User/accountant interface where the user is a profit maximiser

General model USER	Specific application for Retail A Ltd A PROFIT MAXIMISER		General model ACCOUNTANT	Specific application for Retail A Ltd ACCOUNTANT
Step 1 Decision to be made	Appraise which project warrants captial investment	**USER/ ACCOUNTANT INTERFACE**	Identify infomation needed by the user	User decision criterion is IRR
			Measure	Measure the project cash flows
Step 2 Information needed	Project with the highest IRR		Prepare report	Prepare report of highest IRR
Step 3 Seek relevant data	Report of IRR project		Provide report	Submit report of project with highest IRR per £ invested

1.7 Agency costs[2]

The information in Figure 1.2 assumes that the directors have made their investment decision based on the assumed preferences of the shareholders. However, in real life, the directors might also be influenced by how the decision impinges on their own position. If, for example, their remuneration is a fixed salary, they might select not the investment with the highest IRR, but the one that maintains their security of employment. The result might be suboptimal investment and financing decisions based on risk aversion and over-retention. To the extent that the potential cash flows have been reduced, there will be an agency cost to the shareholders. This agency cost is an opportunity cost – the amount that was forgone because the decision making was suboptimal – and, as such, it will not be recorded in the books of account and will not appear in the financial statements.

1.8 Illustration of periodic financial statements prepared under the cash flow concept to disclose realised operating cash flows

In the above example of Retail A, B and C, the investment decision for the acquisition of a warehouse was based on an appraisal of cash flows. This raises the question: 'Why not continue with the cash flow concept and report the financial changes that occur after the investment has been undertaken using that same concept?'

To do this, the company will record the consequent cash flows through a number of subsequent accounting periods; report the cash flows that occur in each financial period; and produce a balance sheet at the end of each of the financial periods. For illustration we follow this procedure in Sections 1.8.1 and 1.8.2 for transactions entered into by Mr T. O'Reilly.

1.8.1 Appraisal of the initial investment decision

Mr O'Reilly is considering whether to start up a retail business by acquiring the lease of a shop for five years at a cost of £80,000.

Our first task has been set out in Figure 1.1 above. It is to establish the information that Mr O'Reilly needs, so that we can decide what data need to be collected and measured. Let us assume that, as a result of a discussion with Mr O'Reilly, it has been ascertained that he is a profit satisficer who is looking to achieve at least a 10% return, which represents the time value of money. This indicates that, as illustrated in Figure 1.2:

- the relevant data to be measured are **cash flows**, represented by the outflow of cash invested in the lease and the inflow of cash represented by the realised operating cash flows;
- the appropriate appraisal method is **NPV**; and
- the appraisal criterion is a **positive NPV** using the discount rate of 10%.

Let us further assume that the cash to be invested in the lease is £80,000 and that the realised operating cash flows over the life of the investment in the shop are as shown in Figure 1.4. This shows that there is a forecast of £30,000 annually for five years and a final receipt of £29,000 in 2026 when he proposes to cease trading.

We already know that Mr O'Reilly's investment criterion is a positive NPV using a discount factor of 10%. A calculation (Figure 1.5) shows that the investment easily satisfies that criterion.

Figure 1.4 Forecast of realised operating cash flows

	Annually years 2021–2025	*Cash in year 2026 after shop closure*
	£	£
Receipts from		
Customers	400,000	55,000
Payments to		
Suppliers	(342,150)	(20,000)
Expense creditors	(21,600)	(3,000)
Rent	(6,250)	(3,000)
Total payments	(370,000)	(26,000)
Realised operating cash flows	30,000	29,000

Figure 1.5 NPV calculation using discount tables

	£	£
Cost of lease		(80,000)
£30,000 annually for 5 years (30,000 × 3.79)	113,700	
£29,000 received in year 6 (29,000 × 0.564)	16,356	
		130,056
Positive net present value		50,056

The accountant's input does not stop there but needs to be proactive. Management will benefit from a report analysing progress at regular intervals showing if the project is on time and within budget and, if not, identifying how to get back to initial plan.

1.8.2 Preparation of periodic financial statements under the cash flow concept

Having **predicted** the realised operating cash flows for the purpose of making the investment decision, we can assume that the owner of the business will wish to obtain **feedback** to evaluate the correctness of the investment decision. He does this by reviewing the actual results on a regular **timely** basis and **comparing** these with the predicted forecast. Actual results should be reported quarterly, half-yearly or annually in the same format as used when making the decision in Figure 1.4. The actual results provide management with the feedback information required to audit the initial decision; it is a technique for achieving accountability. However, frequently, companies do not provide a report of actual cash flows to compare with the forecast cash flows, and fail to carry out an audit review.

In some cases, the transactions relating to the investment cannot be readily separated from other transactions, and the information necessary for the audit review of the investment cannot be made available. In other cases, the routine accounting procedures fail to collect such cash flow information because the reporting systems have not been designed to provide financial reports on a cash flow basis; rather, they have been designed to produce reports prepared on an accrual basis.

What would financial reports look like if they were prepared on a cash flow basis?

To illustrate cash flow period accounts, we will prepare half-yearly accounts for Mr O'Reilly. To facilitate a comparison with the forecast that underpinned the investment decision, we will redraft the forecast annual statement on a half-yearly basis. The data for the first year given in Figure 1.4 have therefore been redrafted to provide a forecast for the half-year to 30 June, as shown in Figure 1.6.

We assume that, having applied the net present value appraisal technique to the cash flows and ascertained that the NPV was positive, Mr O'Reilly proceeded to set up the business on 1 January 2021. He introduced capital of £50,000, acquired a five-year lease for £80,000 and

Figure 1.6 Forecast of realised operating cash flows

	Half-year to 30 June 2021 £
Receipts from	
Customers	165,000
Payments to	
Suppliers	(124,000)
Expense creditors	(18,000)
Rent	(6,250)
Total payments	(148,250)
Realised operating cash flows	16,750

Figure 1.7 Monthly sales, purchases and expenses for six months ended 30 June 2021

Month	Sales invoiced £	Cash received £	Purchases invoiced £	Cash paid £	Expenses invoiced £	Cash paid £
January	15,000	7,500	16,000		3,400	3,100
February	20,000	17,500	19,000	16,000	3,500	3,400
March	35,000	27,500	29,000	19,000	3,800	3,500
April	40,000	37,500	32,000	29,000	3,900	3,800
May	40,000	40,000	33,000	32,000	3,900	3,900
June	45,000	42,500	37,000	33,000	4,000	3,900
TOTAL	195,000	172,500	166,000	129,000	22,500	21,600

Note: The following items were included under the Expenses invoiced heading:
Expense creditors – amount
Wages – £3,100 per month paid in the month
Commission – 2% of sales invoiced payable one month in arrears

paid £6,250 in advance as rent to occupy the property to 31 December 2021. He has decided to prepare financial statements at half-yearly intervals. The information given in Figure 1.7 concerns his trading for the half-year to 30 June 2021.

Mr O'Reilly was naturally eager to determine whether the business was achieving its forecast cash flows for the first six months of trading, so he produced the statement of realised operating cash flows (Figure 1.8) from the information provided in Figure 1.7. From this statement we can see that the business generated positive cash flows after the end of February. These are, of course, only the cash flows relating to the trading transactions.

The information in the 'Total' row of Figure 1.7 can be extracted to provide the financial statement for the six months ended 30 June 2021, as shown in Figure 1.9.

The figure of £15,650 needs to be compared with the forecast cash flows used in the investment appraisal. This is a form of auditing. It allows the assumptions made on the initial investment decision to be confirmed. The forecast/actual comparison (based on the information in Figures 1.6 and 1.9) is set out in Figure 1.10.

Figure 1.8 Monthly realised operating cash flows

	Jan £	Feb £	Mar £	Apr £	May £	Jun £	Total £
Receipts							
Customers	7,500	17,500	27,500	37,500	40,000	42,500	172,500
Less payments							
Suppliers		16,000	19,000	29,000	32,000	33,000	129,000
Expense creditors	3,100	3,400	3,500	3,800	3,900	3,900	21,600
Rent	6,250						6,250
Realised	(1,850)	(1,900)	5,000	4,700	4,100	5,600	15,650

Figure 1.9 Realised operating cash flows for the six months ended 30 June 2021

		£
Receipts from		
Customers		172,500
Payments to		
Suppliers	(129,000)	
Expense creditors	(21,600)	
Rent	(6,250)	
		156,850
Realised operating cash flow		15,650

Figure 1.10 Forecast/actual comparison

		Actual	*Forecast*
		£	£
Receipts from			
Customers		172,500	165,000
Payment to			
Suppliers	(129,000)		(124,000)
Expense creditors	(21,600)		(18,000)
Rent	(6,250)		(6,250)
Total payments		(156,850)	(148,250)
Realised operating cash flow		15,650	16,750

What are the characteristics of these data that make them relevant?

- The data are **objective**. There is no judgement involved in deciding the values to include in the financial statement, as each value or amount represents a verifiable cash transaction with a third party.
- The data are **consistent**. The statement incorporates the same cash flows within the periodic financial report of trading as the cash flows that were incorporated within the initial capital investment report. This permits a logical comparison and confirmation that the decision was realistic.
- The results have a **confirmatory** value by helping users confirm or correct their past assessments.
- The results have a **predictive** value, in that they provide a basis for revising the initial forecasts if necessary.
- There is no requirement for accounting standards or disclosure of accounting policies that are necessary to regulate accrual accounting practices, e.g. depreciation methods.

1.9 Illustration of preparation of statement of financial position

Although the information set out in Figure 1.10 permits us to compare and evaluate the initial decision, it does not provide a sufficiently sound basis for the following:

- assessing the stewardship over the total cash funds that have been employed within the business;
- signalling to management whether its working capital policies are appropriate.

1.9.1 Stewardship

To assess the stewardship over the total cash funds we need to:

(a) evaluate the effectiveness of the accounting system to make certain that all transactions are recorded;

(b) extend the cash flow statement to take account of the capital cash flows; and

(c) prepare a statement of financial position or balance sheet as at 30 June 2021.

The additional information for (b) and (c) above is set out in Figures 1.11 and 1.12 respectively.

Figure 1.11 Cash flow statement to calculate the net cash balance

	Jan £	*Feb* £	*Mar* £	*Apr* £	*May* £	*Jun* £	*Total* £
Operating cash	(1,850)	(1,900)	5,000	4,700	4,100	5,600	15,650
New capital	50,000						50,000
Lease payment	(80,000)						(80,000)
Cash balance	(31,850)	(33,750)	(28,750)	(24,050)	(19,950)	(14,350)	(14,350)

Figure 1.12 Statement of financial position

	Opening 1 Jan 2021 £	*Closing 30 Jun 2021* £
Capital introduced	50,000	50,000
Net operating cash flow		15,650
	50,000	65,650
Lease		80,000
Net cash balance	50,000	–14,350
	50,000	65,650

The cash flow statement and statement of financial position, taken together, are a means of assessing stewardship. They identify the movement of **all** cash and derive a **net** balance figure. These statements are a normal feature of a sound system of internal control, but they have not been made available to external users.

1.9.2 Working capital policies

By 'working capital' we mean the current assets and current liabilities of the business. In addition to providing a means of making management accountable, cash flows are the raw data required by financial managers when making decisions on the management of working capital. One of the decisions would be to set the appropriate terms for credit policy. For example, Figure 1.11 shows that the business will have a £14,350 overdraft at 30 June 2021. If this is not acceptable, management will review its working capital by reconsidering the credit given to customers, the credit taken from suppliers, stock-holding levels and the timing of capital cash inflows and outflows.

If, in the example, it were possible to obtain 45 days' credit from suppliers, then the creditors at 30 June would rise from £37,000 to a new total of £53,500. This increase in trade credit of £16,500 means that half of the May purchases (£33,000/2) would not be paid for until July, which would convert the overdraft of £14,350 into a positive balance of £2,150. As a new business it might not, of course, be always possible to obtain credit from all of the suppliers. In that case, other steps would be considered, such as phasing the payment for the lease of the warehouse or introducing more capital.

An interesting research report[3] identified that, for small firms, survival and stability were the main objectives rather than profit maximisation. This, in turn, meant that cash flow indicators and managing cash flow were seen as crucial to survival. In addition, cash flow information was perceived as important to external bodies such as banks which require detailed cash flow forecasts before considering any application for a loan. Banks such as Barclays[4] assist their customers by making a cash flow forecast tool accessible online.

1.10 Treatment of non-current assets in the cash flow model

The statement of financial position in Figure 1.12 does not take into account any **unrealised** cash flows. Such flows are deemed to occur as a result of any rise or fall in the realisable value of the lease. This could rise if, for example, the annual rent payable under the lease were to be substantially lower than the rate payable under a new lease entered into on 30 June 2021. It could also fall with the passing of time, with six months having expired by 30 June 2021. We need to consider this further and examine the possible treatment of non-current assets in the cash flow model.

Using the cash flow approach, we require an independent verification of the realisable value of the lease at 30 June 2021. If the lease has fallen in value, the difference between the original outlay and the net realisable figure could be treated as a negative unrealised operating cash flow.

For example, if the independent estimate was that the realisable value was £74,000, then the statement of financial position would be prepared as in Figure 1.13. The fall of £6,000 in realisable value is an unrealised cash flow and, while it does not affect the calculation of the net cash balance, it does affect the statement of financial position.

The same approach would be taken to all non-current assets and could result in there being an unrealised cash flow where there is limited resale market for an asset, even though it might be productive and have value in use by the firm that owns it.

Figure 1.13 Statement of financial position as at 30 June 2021 (assuming that there were unrealised operating cash flows)

	£
Capital introduced	50,000
Net operating flow: **realised**	15,650
: **unrealised**	(6,000)
	59,650
Lease: **net realisable value**	74,000
Net cash balance	–14,350
	59,650

The additional benefit of the statement of financial position, as revised, is that the owner is able clearly to identify the following:

- the operating cash inflows of £15,650 that have been realised from the business operations;
- the operating cash outflow of £6,000 that has not been realised, but has arisen as a result of investing in the lease;
- the net cash balance of –£14,350;
- the statement provides a **stewardship-oriented** report: that is, it is a means of making the management accountable for the cash within its control.

1.11 What are the characteristics of these data that make them reliable?

We have already discussed some characteristics of cash flow reporting which indicate that the data in the financial statements are **relevant**, e.g. their predictive and confirmatory roles. We now introduce five more characteristics of cash flow statements which indicate that the information is also **reliable**, i.e. free from bias. These are prudence, neutrality, completeness, faithful representation and substance over form.

1.11.1 Prudence characteristic

Revenue and profits are included in the cash flow statement only when they are realised. Realisation is deemed to occur when cash is received. In our O'Reilly example, the £172,500 cash received from debtors represents the revenue for the half-year ended 30 June 2021. This policy is described as prudent because it **does not anticipate** cash flows: cash flows are recorded only when they actually occur and not when they are reasonably certain to occur. This is one of the factors that distinguishes cash flow from accrual accounting.

1.11.2 Neutrality characteristic

Financial statements are not neutral if, by their selection or presentation of information, they influence the making of a decision in order to achieve a predetermined result or outcome. With cash flow accounting, the information is not subject to management selection criteria.

Cash flow accounting avoids the tension that can arise between prudence and neutrality because, while neutrality involves freedom from deliberate or systematic bias, prudence is a

potentially biased concept that seeks to ensure that, under conditions of uncertainty, gains and assets are not overstated and losses and liabilities are not understated.

1.11.3 Completeness characteristic

The cash flows can be verified for completeness provided there are adequate internal control procedures in operation. In small and medium-sized enterprises there can be a weakness if one person, typically the owner, has control over the accounting system and is able to under-record cash receipts.

1.11.4 Faithful representation characteristic

Cash flows can be depended upon by users to represent faithfully what they purport to represent provided, of course, that the completeness characteristic has been satisfied.

1.11.5 Substance over form

Cash flow accounting does not necessarily possess this characteristic, which requires that transactions should be accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

1.12 Reports to external users

1.12.1 Stewardship orientation

Cash flow accounting provides objective, consistent and prudent financial information about a business's transactions. It is stewardship-oriented and offers a means of achieving accountability over cash resources and investment decisions.

1.12.2 Prediction orientation

External users are also interested in the ability of a company to pay dividends. It might be thought that the past and current cash flows are the best indicators of future cash flows and dividends. However, the cash flow might be misleading, in that a declining company might sell non-current assets and have a better **net cash position** than a growing company that buys non-current assets for future use. There is also no matching of cash inflows and outflows, in the sense that a benefit is matched with the sacrifice made to achieve it.

Consequently, it has been accepted accounting practice to view the income statement prepared on the accrual accounting concept as a better predictor of future cash flows to an investor than the cash flow statements that we have illustrated in this chapter.

However, the operating cash flows arising from trading and the cash flows arising from the introduction of capital and the acquisition of non-current assets can become significant to investors, e.g. they may threaten the company's ability to survive or may indicate growth.

1.12.3 Going concern

The Financial Reporting Council suggests in its Consultation Paper *Going Concern and Financial Reporting*[5] that directors, in assessing whether a company is a going concern, may prepare monthly cash flow forecasts and monthly budgets covering, as a minimum, the period