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Management Accounting

Unit 2

Q: What is Funds Flow Statement? What are its objectives? What are the uses of Funds Flow Statement? *(www.prepnext.com)*

Ans:

<u>Statement of Changes in Financial Position (Funds Flow Statement)</u>

The Funds Flow Statement is a statement which shows the movement of funds. It indicates various means by which funds were obtained during a particular period and the ways in which these funds were employed. In simple words, it is a statement of sources and applications of funds. Funds Flow Statement is a method by which we study changes in the financial position of a business enterprise between beginning and ending financial statements dates. The term 'funds' used here means working capital, i.e., the excess of current assets over current liabilities.

The statement is known by various titles, such as, Statement of Sources and Applications of Funds, Statement of Changes in Working Capital, where Got and Gone Statement and Statement of Resources Provided and Applied.

Foulke defines this statement as: "A statement of sources and application of funds is a technical device designed to analyse the changes in the financial condition of a business enterprise between two dates".

In the words of **Anthony**, "The funds flow statement describes the sources from which additional funds were derived and the use to which these sources were put".

I.C.W.A. in Glossary of Management Accounting terms defines Funds Flow Statement as "a Statement either prospective or retrospective, setting out the sources and applications of the funds of an enterprise. The purpose of the statement is to indicate clearly the requirement of funds and how they are proposed to be raised and the efficient utilisation and application of the same."

Objectives of Funds Flow Statement:

The main purposes of such statements are:

1) To help to understand the changes in assets and asset sources which are not readily evident in the income statement or the financial position statement.
2) To inform as to how the loans to the business have been used, and
3) To point out the financial strengths and weaknesses of the business.

(Points from advantages/ importance, given below, may also be included in objectives of Funds Flow Statement)

USES, SIGNIFICANCE AND IMPORTANCE OF FUNDS FLOW STATEMENT:

A funds flow statement is an essential tool for the financial analysis and is of primary importance to the financial management. Now-a-days, it is being widely used by the financial analysts, credit granting institutions and financial managers. The significance of funds flow statement can be well followed from its various uses given below:

1) It helps in the analysis of financial operations:

The financial statements reveal the net effect of various transactions on the operational and financial position of a concern. The balance sheet gives a static view of the resources of a business. But it does not disclose the causes for changes in the assets and liabilities between two different points of time. The funds flow statement explains causes for such changes and also the effect of these changes on the liquidity position of the company. Sometimes a concern may operate profitably and yet its cash position may become more and more worse. The funds flow statement gives a clear answer to such a situation explaining what has happened to the profits of the firm.

2) It answers many intricate/ *complex* queries

It throws light on many perplexing questions of general interest which otherwise may be difficult to be answered, such as:

(i) Why were the net current assets lesser in spite of higher profits and vice-versa?
(ii) Why more dividends could not be declared in spite of available profits?
(iii) How was it possible to distribute more dividends than the present earnings?
(iv) What happened to the net profit? Where did they go?
(v) What are the sources of repayment of debt?
(vi) How was the increase in working capital financed and how will it be financed in future?
(vii) What happened to the proceeds of sale of fixed assets or issue of shares, debentures, etc?
(viii) What is the overall credit-worthiness of the enterprise?

3) It helps in the formation of a realistic dividend policy.

Sometimes a firm has sufficient profits available for distribution as dividend but yet it may not be advisable to distribute dividend for lack of liquid or cash resources. In such cases, a funds flow statement helps in the formation of a realistic dividend policy.

4) It helps in the proper allocation of resources:

The resources of a concern are always limited and it wants to make the best use of these resources. A projected funds flow statement constructed for the future helps in making managerial decisions. The firm can plan the deployment of its resources and allocate them among various applications.

5) It acts as a future guide.

A projected funds flow statement also acts as a guide for future to the management. The management can come to know the various problems it is going to face in near future for want of funds. The firm's future needs of funds can be projected well in advance and also the timing of these needs. The firm can arrange to finance these needs more effectively and avoid future problems.

6) It helps in appraising the use of working capital:

A funds flow statement helps in explaining how efficiently the management has used its working capital and also suggests ways to improve working capital position of the firm. *It tells the financial analyst about the adequacy or inadequacy of working capital during a particular period and the steps which the management should take for the effective use of surplus working capital or arrangements which should be made in case of inadequacy of working capital.*

7) It helps knowing the overall creditworthiness of a firm *(It helps in borrowing from financial institutions)***:**

Lending institutions such as banks, I.F.C., I.D.B.I. etc. all ask for funds flow statement constructed for a number of years before granting loans to know the creditworthiness and paying capacity of the firm. Hence, a firm seeking financial assistance from these institutions has no alternative but to prepare funds flow statements.

In short, this statement helps management in taking better decisions in formulating more accurate policies and thus leading into more healthy and profitable organisation.

Q: What are the limitations of Funds Flow Statement?

(www.prepnext.com)

Ans:

The funds flow statement has a number of uses. However, it has certain limitations also, which are listed below:

1) A funds flow statement is not a substitute of an income statement or a balance sheet. It provides only some additional information as regards changes in working capital.
2) It cannot reveal continuous changes.
3) It is not an original statement but simply re-arrangement of data given in the financial statements.
4) It is essentially historic in nature and projected funds flow statement cannot be prepared with much accuracy.
5) Changes in cash are more important and relevant for financial management than the working capital.
6) Funds flow statement is generally prepared on working capital basis. Working capital includes items like inventories and prepaid expenses which are not easily convertible into cash within a short period, and which do not contribute to the ability of a firm to pay its short term obligations as and when they become due.
7) There is no standard format for the preparation of funds flow statement. As such, firms have adopted different methods for preparing the statement making comparisons difficult.
8) The funds flow statement does not disclose flows from operating, investing and financing activities separately. It merely provides information regarding inflows and outflows of funds.

Q: Explain briefly the transactions that bring about a change in the working capital. *(www.prepnext.com)*

Ans:

The change in the working capital (flow of funds) occurs when a transaction changes on the one hand a non-current account and on the other a current account and vice-versa. In simple language funds move when a transaction affects: (i) a current asset and a non-current asset, or (ii) a current asset and a non-current liability, or (iii) a current liability and a non-current liability, or (iv) a current liability and a non-current asset. Funds do not move when the transaction affects (i) non-current asset and non-current liability, or (ii) current assets and current liabilities.

Following transactions will bring the change in the working capital:

1) Current Assets and Non-current Assets:

Whenever in any transaction one aspect affects the current assets and the other non-current assets, there is flow in the working capital. For example, when building is purchased for cash, non-current assets will increase and current assets will reduce, thereby decreasing working capital. Similarly, if any fixed asset is sold for cash, there is increase in current assets and reduction in non-current assets; so it will increase the working capital.

2) Current Assets and Non-current Liabilities:

If in any transaction, one aspect affects the current assets and the other non-current liabilities, there will be flow in the working capital. For example, if equity shares are issued for cash, it will increase the cash (current assets) and also increase the equity share capital (non-current liabilities). There is increase in working capital. On the other hand, if long term liabilities i.e, debentures are paid in cash, it will decrease the current assets and decrease the non-current liabilities; so it will reduce the working capital.

3) Current Liabilities and Non-current Liabilities:
If in any transaction, one aspect affects the current liabilities and the other non-current liabilities, there will be flow in the working capital. For example, if debentures are issued to the creditors it will increase the non-current liabilities and decrease the current liabilities; so there will be increase in the working capital.

4) Current Liabilities and Non-current Assets:
If in any transaction, one aspect affects the current liabilities and the other non-current assets, there is flow in the working capital. For example, if building is purchased on credit, it will increase the non-current assets and also current liabilities; so there will be decrease in the working capital.

In short, it can be said that when one aspect is of non-current category, and the other of current category, there will be flow in funds.

Q: What is the Procedure for Knowing Whether a Transaction Results in the Flow of Funds or Not? *(www.prepnext.com)*

Ans:

Procedure for Knowing Whether a Transaction Results in the Flow of Funds or Not:

Flow of funds is said to have taken place when any transaction makes changes in the amount of funds available before happening of the transaction. If the effect of transaction results in the increase of funds, it is called a source of funds and if it results in the decrease of funds, it is known as an application of funds. Further, in case the transaction does not change funds, it is said to have not resulted in the flow of funds. According to the working capital concept of funds, the term 'flow of funds' refers to the movement of funds in the working capital. If any transaction results in the increase in working capital, it is said to be a source or inflow of funds and if it results in the decrease of working capital, it is said to be an application or out-flow of funds.

The flow of funds occurs when a transaction changes on the one hand a non-current account and on the other a current account and vice-versa. The Procedure for Knowing Whether a Transaction Results in the Flow of Funds or Not is discussed below:

1) Analyse the transactions and find out the two accounts involved.
2) Make Journal Entry of the transaction
3) Determine whether the accounts involved in the transaction are current or non-current.
4) If both the accounts involved are current i.e., either current assets or current liabilities, it does not result in the flow of funds.
5) If both the accounts involved are non-current i.e., either permanent assets or permanent liabilities, it still does not result in the flow of funds.
6) If the accounts involved are such that one is a current account while the other is a non-current account, i.e., current assets and permanent liability, or current asset and fixed asset, or current liability and fixed asset, or current liability and permanent liability then it results in the flow of funds.

Examples:

(A) Transactions which involve only the current accounts and hence do not result in the flow of funds:

1) Cash collected from debtors
2) Cash paid to creditors
3) Goods purchased for cash or credit
4) Payment of Bills Payable
5) Raising of short-term loans.

(B) Transactions which involve only non-current accounts and hence do not result in the flow of funds:

1) Conversion of debentures into shares
2) Transfer to General Reserves, etc.
3) Writing off of fictitious assets
4) Payment of bonus in the form of shares
5) Purchase of fixed assets in exchange of shares, debentures, bonds, or long-term loans.

(C) Transactions which involve both current and non-current accounts and hence result in the flow of funds:
1) Issue of shares or debentures for cash
2) Redemption of preference shares or debentures.
3) Payment of bonus in cash
4) Repayment of long-term loans
5) Purchase of fixed assets on cash or credit.
6) Raising of long-term loans.
7) Sale of fixed assets on cash or credit.

[The answer to this question may be supplemented by including a portion of the answer to the question:- "Explain briefly the transactions that bring about a change in the working capital"]

Q: Explain briefly the transactions that do not affect the flow of funds *(www.prepnext.com)*

Ans:
When a change in a non-current account e.g., fixed assets, long-term liabilities, reserves and surplus, fictitious assets, etc. is followed by a change in another non-current account, it does not amount to flow of funds. This is because of the fact that in such cases neither the working capital increases nor decreases. Similarly, when a change in one current account results in a change in another current account, it does not affect funds.

Following transactions will not bring any change in the working capital and thus, there will be no flow in funds:

1) Current Assets and Current Liabilities:
When in any transaction one aspect affects the current assets and other current liabilities, there is no flow in funds. For example, if goods are sold on credit, it will increase the debtors (current assets) and will reduce the stock of goods. So there will be no change in the working capital. Similarly, if cash is paid to creditors, it will decrease the current assets and decrease the current liabilities, there will be no change in the working capital.

2) Non- current Assets and Non-current Liabilities:

If in any transaction, one aspect affects the non-current assets and the other non-current liabilities, there will not be any change in the working capital. For example, if building is purchased by the issue of equity shares, it will increase the non-current assets and non-current liabilities, but there will not be any change in working capital. Similarly, if debentures are redeemed out of the amount received from the sale of machinery, it will reduce the non-current assets and non-current liabilities. But there will be no change in working capital

3) Non-current Liabilities (or Non-current Assets):

If there is any transaction both aspects of which affect non-current liabilities (or non-current assets), it will not affect the working capital. For example, if debentures are converted into share capital it will on one hand increase the non-current liabilities and on the other hand decrease the non-current liabilities

From the above discussion we conclude:

(i) When both aspects of a transaction belong to non-current category (either non-current assets or non-current liabilities or one aspect is non-current asset and the other non-current liability) or are of current category i.e, current assets or current liabilities or when one aspect is a current asset and the other current liability, then such transactions will not bring flow in funds.

(ii) When out of both aspects of a transaction one aspect belongs to non-current category and the other current category i.e, one aspect is current asset or current liability and the other non-current asset or non-current liability, this will bring the flow in funds.

Q: Distinguish between Funds Flow Statement and Income Statement. *(www.prepnext.com)*

Ans:

Differences between Funds Flow Statement and Income Statement

Basis of Difference	Funds Flow Statement	Income Statement
Disclosure in Statement	It highlights the changes in the financial position of a business and indicates the various means by which funds were obtained during a particular period and the ways to which these funds were employed.	It does not reveal the inflows and outflows of funds but depicts the items of expenses and income that helped to arrive at the figure of profit or loss.
Basis	It is complementary to income statement. Income statement helps the preparation of Funds Flow Statement.	Income statement is not prepared from Funds Flow Statement
Subject matter	While preparing Funds Flow Statement both capital and revenue items are considered.	Only revenue items are considered.
Format	There is no prescribed format for preparing a Funds Flow Statement.	It is prepared in a prescribed format.
Matching	This statement matches the funds raised with funds applied without making any distinction between capital and revenue items.	This matches the cost of goods sold with the revenue in order to know the profits or loss.
Period of Preparation	It is prepared as per the need of the management. It can be prepared monthly, quarterly, yearly, or for two, three, four or more years.	It is usually prepared after six months or a year
Depicts what?	It depicts the comparative position of working capital on two balance sheet dates.	It depicts the profit or loss made during a specified period.

Reliability	It is more reliable as items shown in this statement cannot be easily manipulated by the management.	It is not very reliable as items shown in profit or loss account like depreciation or valuation of closing stock can be easily manipulated by the management.
When Prepared?	It can be prepared before the actual operations of the business for efficient working capital management.	It is always prepared after the actual operations of the business.
Scope	It presents information only relating to working capital and thus its scope is limited.	It presents the result of all financial transactions of the business during a specified period.
Balance Represents	The excess of sources over application is known as increase in working capital while the excess of applications over sources is known as decrease in working capital.	The excess of incomes and gains over expenses and losses is known as net profit and the excess of expenses and losses over incomes and gains is known as net loss.

Q: Distinguish between Funds Flow Statement and Balance Sheet.

(www.prepnext.com)

Ans:

A balance sheet is a statement of financial position or status of a business on a given date. Funds flow statement is essentially a post balance sheet exercise. It is prepared to show various sources from which funds came into business and various applications where they have been used.

Funds Flow Statement is not competitive but complementary to financial statements (Income Statement and Balance Sheet). The funds statement provides additional information as regards changes in working capital, derived from financial statements at two points of time. It is a tool of management for financial analysis and helps in making decisions.

Basis of Difference	Funds Flow Statement	Balance Sheet
Nature	It is a statement of changes in financial position and hence is dynamic in nature.	It is a statement of financial position on a particular date and hence is static in nature.
Depicts what?	It shows the sources and uses of funds during a particular period of time.	It depicts the assets and liabilities at a particular point of time.
Assistance in Decision making	It is a tool of management for financial analysis and helps in making decisions.	It is not of much help to management in making decisions.
Schedule of Changes in Working Capital	Usually, Schedule of Changes in Working Capital has to be prepared before preparing Funds Flow Statement.	No such Schedule of Changes in Working Capital is required. Rather Profit and Loss Account is prepared.
Meaning	It is a statement which describes from where the funds have been derived and the uses to which these funds were put.	Balance sheet is a statement of debit and credit balances prepared on a particular date.
Period of Preparation	It is prepared as per the need of the management. It can be prepared monthly, quarterly, yearly, or for two, three, four or more years.	It is a yearly affair throughout the whole life of the business.
Publication	It, being, a tool of management technique is published only under special circumstances.	It is generally published annually by the management as besides owners, others also have interest in smooth running of the business.

Components	It includes only those accounts which affect working capital.	It contains balances of personal and real accounts.
Purpose	Prepared to know the sources and uses of the working capital.	Prepared to ascertain the financial position of the business on a certain date.
Earnings	In it, all earnings are treated as source of funds.	Only retained earnings are treated as source of funds.

Q: *Distinguish between Funds Flow Statement and Schedule of Changes in Working Capital.* *(www.prepnext.com)*

Ans:

Sl. No.	***Basis of Difference***	***Funds Flow Statement***	***Schedule of Changes in Working Capital***
1	*Meaning*	*It tells from where the funds have been derived and the uses to which they have been put.*	*It shows the increase or decrease in working capital due to changes in current assets and current liabilities.*
2	*Format*	*It can be prepared both in 'T' form or statement form*	*It is prepared in statement form only*
3	*Coverage*	*It includes all non-current items and net result of current items.*	*It includes all current items only.*

Q: Explain the procedure of preparation of Funds Flow Statement.

(www.prepnext.com)

Ans:

Funds flow statement is a method by which we study changes in the financial position of a business enterprise between beginning and ending financial statements dates. Hence, the funds flow statement is prepared by comparing two balance sheets and with the help of such other information derived from the accounts as may be needed. Broadly speaking, the preparation of a funds flow statement consists of two parts:

(1) Statement or Schedule of Changes in Working Capital
(2) Statement of Sources and Application of Funds

(1) Statement or Schedule of Changes in Working Capital:

Working capital means the excess of current assets over current liabilities. Statement of changes in working capital is prepared to show the changes in the working capital between the two balance sheet dates. This statement is prepared with the help of current assets and current liabilities derived from the two balance sheets.

As, Working Capital = Current Assets – Current Liabilities

So, (i) An increase in current assets increases working capital
(ii) A decrease in current assets decreased working capital.
(iii) An increase in current liabilities decreases working capital; and
(iv) A decrease in current liabilities increases working capital.

The change in the amount of any current asset or current liability in the current balance sheet as compared to that of the previous balance sheet either results in increase or decrease in working capital. The difference is recorded for each individual current asset and current liability. The total increase and the total decrease are compared and the difference shows the net increase or net decrease in working capital.

A typical form of statement or schedule of changes in working capital is as follows:

Statement or Schedule of Changes in Working Capital				
Particulars	Previous Year	Current Year	Effect on Working Capital	
			Increase	Decrease
Current Assets: Cash in hand Cash at bank Bills Receivable Sundry Debtors Temporary Investments Stocks/ Inventories Prepaid Expenses Accrued Incomes				
Total Current Assets				
Current Liabilities: Bills Payable Sundry Creditors Outstanding Expenses Bank Overdraft Short-term advances Dividends Payable Proposed dividends * Provision for taxation *				
Total Current Liabilities				
Working Capital (CA – CL)				
Net Increase or Decrease in Working Capital				

*May or may not be a current liability

(2) Statement of Sources and Application of Funds:

Funds flow statement is a statement which indicates various sources from which funds (working capital) have been obtained during a certain period and the uses or applications to which these funds have been put during that period. Generally, this statement is prepared in two formats:

(i) Report Form
(ii) T Form or An Account Form or Self Balancing Type

The items of sources and applications are given as follows:

Sources of Funds:

Following are the sources from which funds come:

(i) Funds from operations
(ii) Income from investments
(iii) Issue of shares and debentures
(iv) Raising a loan
(v) Sale of fixed assets and long-term investments
(vi) Receipt of interest on non-trade investments, dividends, refund of tax etc.
(vii) Decrease in working capital etc.

Uses (or Applications) of Funds:

Following are the various purposes for which funds can be used.

(i) Funds lost in operations
(ii) Repayment of long-term loans
(iii) Redemption of preference shares and debentures
(iv) Purchase of fixed assets
(v) Purchase of long-term investments
(vi) Payment of cash dividends
(vii) Payment of taxes
(viii) Drawings in case of proprietary or partnership business
(ix) Loss of cash by embezzlement
(x) Increase in working capital, etc.

Specimen of Report Form of Funds Flow Statement	
	Rs.
Sources of Funds: *Funds from Operations* *Issue of Share Capital* *Issue of Debentures* *Raising of long-term loans* *Receipts from partly paid shares, called up* *Sales of non-current (fixed) assets* *Non-trading receipts, such as dividends received* *Sale of Investments (long-term)* *Decrease in Working Capital (as per schedule of changes in Working Capital)*	
Total	
Applications or Uses of Funds: *Funds Lost in Operations* *Redemption of Preference Share Capital* *Redemption of Debentures* *Repayment of long-term loans* *Purchase of non-current (fixed) assets* *Purchase of long-term Investments* *Non-trading payments* *Payments of dividends** *Payment of tax** *Increase in Working Capital (as per schedule of changes in Working Capital)*	
Total	

T Form, An Account Form or Self Balancing Type
Funds Flow Statement
(For the year ended…….)

Sources	Rs.	Applications	Rs.
Funds from Operations		Funds Lost in Operations	
Issue of Share Capital		Redemption of Preference Share Capital	
Issue of Debentures		Redemption of Debentures	
Raising of long-term loans		Repayment of long-term loans	
Receipts from partly paid shares, called up		Purchase of non-current (fixed) assets	
Sales of non-current (fixed) assets		Purchase of long-term Investments	
Non-trading receipts, such as dividends received		Non-trading payments	
Sale of Investments (long-term)		Payments of dividends*	
Net Decrease in Working Capital		Payment of tax*	
		Net Increase in Working Capital	

* Payment of dividend and tax will appear as an application of funds only when these items are appropriations of profits and not current liabilities.

(Note: In exams, you may show only one format:- preferably T Form)

Q: Explain the treatment of following items in a funds flow statement:

i) Proposed Dividend
ii) Provision for Income Tax
iii) Interim Dividend

(www.prepnext.com)

Ans:

(i) PROPOSED DIVIDEND:

Proposed dividend though shown on the liabilities side of a Balance Sheet is not a liability in real sense until it is formally declared to be paid to the shareholders in the Annual General Meeting of the Company. Till such declaration of dividends, it simply represents an appropriation of profits and is like a reserve or surplus. But generally, declaration of dividends proposed by the directors are accepted in the shareholders meeting. In that case, proposed dividend cannot be said to be an appropriation of profits as these become payable within a short time after they are proposed. So there are two alternatives to deal with this item in the same way as that of provision for taxation.

(a) As a current liability:

When proposed dividend is treated as a current liability it represents an obligation of the company which is payable in short period. Hence**, it is shown in the schedule of changes in working capital as a current liability and it requires no further treatment in the funds flow statement**.

(b) As an appropriation of profits:

When proposed dividend is treated as an appropriation of profits, it is not a current liability and hence will not be shown in the schedule of changes in working capital. In this case, **dividends proposed during the year, being an appropriation, are added back (or shown on the debit side of adjusted profit and loss account) while finding funds from operations. Thus, dividends paid during the year represent an application of funds and have to be shown on the application side of funds flow statement.**

In the absence of any information, proposed dividend for the previous year may be assumed to be paid during the year and taken as an application of funds while the proposed dividend of the current year, being an appropriation, may be added while finding funds from operations.

A provision for taxation account may have also to be prepared in case of hidden information, i.e, when the provision for taxation made during the year or the taxes paid during the year are not given.

(ii) PROVISION FOR TAXATION:

There are two ways of dealing with provision for taxation:

(a) As a current liability
(b) As an appropriation of profits

(a) As a Current Liability:

Provision for taxation may be treated as a current liability as it, generally, represent an immediate obligation of the company to pay tax to the Government. When it is treated as a current liability**, provision for taxation will appear in the schedule of changes in working capital like all other current liabilities and no further treatment is required while preparing the funds flow statement.** *In this case, there is no need to prepare the provision for Taxation Account and the payment of tax made during the year shall not be shown as an application of funds because in that case both the accounts involved for the payment of tax shall be current accounts, e.g., the entry for taxes paid during the year shall be:*

Provision for Taxation A/C Dr. (already taken as Current Liability)
To Cash A/C (Current Asset)

It is clear from the above entry that only the current accounts are involved and hence there is no movement of funds (Working Capital)

(b) As an appropriation of profits:

When the provision for taxation is treated as an appropriation of profits and not as a current liability, then it shall not appear in the schedule of changes in working capital. **Provision for taxation** made during the year then shall be the appropriation of profits made during the year and **will have to be added back while finding funds from operations being a non-fund item. If an adjusted profits and loss account is prepared, provision for taxation made during the year shall appear on the debit side for the same reasons. Moreover, the taxes paid during the year shall be an application of funds (not being a current liability) and will have to be shown in the funds flow statement on the application side.**

A provision for taxation account may have also to be prepared in case of hidden information, i.e, when the provision for taxation made during the year or the taxes paid during the year are not given.

(iii) <u>INTERIM DIVIDEND:</u>

The expression 'interim dividend' denotes a dividend paid to the member of the company during a financial year, before the finalisation of annual accounts. The dividend paid or declared in between the two Annual General Meetings, i.e., interim dividend, should be added back (or debited in the adjusted profit and loss account) while calculating funds from operations. However, if the figure of profit is taken prior to the debit of interim dividend this adjustment is not required. The interim dividend is also an application of funds and has to appear on the application side of funds flow statement.

Q: What is Cash Flow Statement? What are its objectives?

(www.prepnext.com)

Ans:

Cash flow statement is a statement which describes the inflows (sources) and outflows (uses) of cash and cash equivalents in an enterprise during a specified period of time. This statement reports cash receipts and payments classified according to the entity's major activities – operating, investing and financing during the period in a format that reconciles the beginning and ending cash balance.

According to AS-3 (Revised), an enterprise should prepare a cash flow statement and should present it for each period for which financial statements are prepared. The terms cash, cash equivalents and cash flows are used in this statement with the following meanings:

(i) Cash comprises cash on hand and demand deposits with banks.

(ii) Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

OBJECTIVES:

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainly of their generation.

The Statement deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

Q: How a Cash Flow Statement can be prepared?

(www.prepnext.com)

Ans:

PROCEDURE FOR PREPARING A CASH FLOW STATEMENT:

An organisation should prepare a cash flow statement according to Accounting Standard – 3. Cash flow statement is prepared with the help of financial statements. The basic information required for the preparation of a cash flow statement is obtained from the following sources:

(i) Comparative balance sheets at two points of time, i.e. in the beginning and at the end of the accounting period.
(ii) Income statement of the current accounting period or the profit and loss account.
(iii) Some selected additional data to extract the hidden transactions.

This statement is prepared in three stages as given below:

(i) Net profit before taxation and extraordinary items.
(ii) Cash flows from operating, investing and financing activities.
(iii) Cash Flow Statement.

The preparation of a cash flow statement involves the following steps:

Step 1: Compute the net increase or decrease in cash and cash equivalents by making a comparison of these accounts given in the comparative balance sheets.

Step 2: Calculate the net cash flow provided (used in) operating activities by analysing the profit and loss account, balance sheet and additional information. There are two methods of converting net income into net cash flows from operating activities: the direct method and the indirect method.

Cash Flow from Operating Activities – Direct Method

Each item in the income statement is adjusted from accrual basis to cash basis, in order to determine and list each cash receipt and cash payment as cash inflows and outflows from operating activities. The net amount is reported in the last as cash provided (or used) from operating activities.

Cash Flow from Operating Activities – Indirect Method:

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effect of:

(a) Changes during the period in inventories and operating receivables and payables;

(b) Non-cash items such as depreciation, provisions, deferred taxes, and unrealized foreign exchange gains and losses; and

(c) All other items for which the cash effects are investing or financing cash flows.

Step 3: Calculate the net cash flow from investing activities

Step 4: Calculate the net cash flow from financing activities.

Step 5: Prepare a formal cash flow statement highlighting the net cash flow from (used in) operating, investing and financing activities separately.

Step 6: Make an aggregate of net cash flows from the three activities and ensure that the total net cash flow is equal to the net increase or decrease in cash and cash equivalents as calculated in Step 1.

Step 7: Report significant non-cash transactions that did not involve cash or cash equivalents in a separate schedule to the cash flow statement e.g., purchase of machinery against issue of share capital or redemption of debentures in exchange for share capital.

Format of Cash Flow Statement

Cash Flow Statement

(for the year ended……………..)

	Rs.	Rs.
Cash Flows from Operating Activities		
Either		
Cash receipts from customers	xxx	
Cash paid to suppliers and employees	(xxx)	
Cash generated from operations	xxx	
Income-tax paid	(xxx)	
Cash flow before extraordinary items	xxx	
Extraordinary Items	xxx	
Net Cash from (used in) operating activities		xxx
Or		
Net profit before tax and extraordinary items	xxx	
Adjustments for non-cash and non-operating items		
(List of individual items such as depreciation, foreign exchange gain/ loss, gain/ loss on sale of fixed assets, interest income, dividend income, interest expenses, etc.)	xxx	
Operating Profit before working capital changes	xxx	
Adjustments for changes in current assets and current liabilities (List of individual items)	xxx	
Cash generated from (used in) operations before tax	xxx	
Income tax paid	(xxx)	
Cash flow before extraordinary items	xxx	
Extraordinary items (such as refund of tax)	xxx	
Net cash from (used in) operating activities		xxx

Cash Flows from Investing Activities		
Individual Items of cash inflows and outflows from investing activities (such as purchase/ sale of fixed assets, purchase or sale of investments, interest received, dividend received etc.	xxx xxx	
Net cash from (used in) investing activities		xxx
Cash Flows from Financing Activities		
Individual items of cash inflows and outflows from financing activities (such as proceeds from issue of shares, long-term borrowings, repayments of long-term borrowings, interest paid, dividend paid etc.)	xxx xxx	
Net cash from (used in) financing activities		xxx
Net Increase (Decrease) in cash and cash equivalents		xxx
Cash and cash equivalents at the beginning of the period		xxx
Cash and cash equivalents at the end of the period		xxx

Q: What are the uses/ Significance of Cash Flow Statement? Explain briefly the limitations of Cash Flow Statement.

(www.prepnext.com)

Ans:

USEFULNESS OF CASH FLOW STATEMENT:

Cash flow statement is of vital importance to the financial management. It is an essential tool of financial analysis for short-term planning. The chief advantages of cash flow statement are as follows:

(i) Predicts Future Cash Flows:

A projected cash flow statement can be prepared in order to know the future cash position of a concern so as to enable a firm to plan and coordinate its financial operations properly. By preparing this statement, a firm can come to know as to how much cash will be generated into the firm and how much cash will be needed to make various payments and hence the firm can well plan to arrange for the future requirements of cash.

(ii) Determines the Ability to Pay Dividends and other Commitments:

This statement indicates the sources and uses of cash under operating, investing and financing activities. It helps shareholders to know whether the business can make the payment of amount of dividends on their investment in shares. It also indicated whether the creditors can receive interest and principal amount in time.

(iii) Shows the Relationship of Net Income to Changes in the Business Cash:

Generally there is direct relation between net income and cash. High net income leads to increase in cash and vice versa. But there may be a situation where a company's net income is high but decrease in cash balance and increase in cash balance when net income is low. This statement helps the users to know the reasons of difference between the net income and net cash provided by operations.

(iv) Efficiency in Cash management:

This statement helps the management to make the reliable cash flow projections for the immediate future and will tell surplus or deficiency of cash so that management may be able to make plan for investment of surplus cash or to tap the sources where from the deficiency is to be met. Thus it is an important financial tool for the management as it helps in the efficient cash management.

(v) Discloses Movement of Cash:

Previous year cash flow statement when compared with the budget of that year will indicate as to what extent the resources of the enterprise were raised and applied. Actual results when compared with the original forecast may highlight the trend of the movement of cash that may otherwise remain undetected.

(vi) Discloses Success or Failure of Cash Planning:

A comparison of projected cash flow statement with the actual cash flow statement will reveal the success or failure of cash planning and in case of failure, necessary remedial steps can be taken to improve the position. It also provides a better measure for inter period and inter firm comparison.

(vii) Evaluates Management Decisions:

Cash flow statement provides information of all activities classified under operating, investing and financing activities. This helps the investors and creditors to evaluate management decisions.

(viii) More useful than the Funds Flow Statement:

Cash flow analysis is more useful and appropriate than funds flow analysis for short-term financial analysis as in a very short period it is cash which is more relevant than the working capital for forecasting the ability of the firm to meet its immediate obligations.

(ix) Enhances the Comparability of Report:

Cash flow statement prepared according to AS-3 (Revised) is more suitable for making comparisons than the funds flow statement as a standard format is used for the same. This eliminates the effect of using different accounting treatments for the same transactions and events. A series of intra-firm and inter-firm cash flow statements reveals whether the firm's liquidity (short-term paying capacity) is improving or deteriorating over a period of time and in comparison to other firms over a given period of time.

(x) Helps in Planning and Decision making:
Cash flow statement helps in planning the repayment of loans, replacement of fixed assets and other similar long-term planning of cash. It is also significant for capital budgeting decisions.

(xi) Answers many intricate queries:
It better explains the causes for poor cash position inspite of substantial profits in a firm by throwing light on various applications of cash made by the firm. It further helps in answering some intricate questions like – what happened to the net profits? Where does the profits go? Why more dividends could not be paid inspite of sufficient available profit?

LIMITATIONS OF CASH FLOW STATEMENT:

Despite a number of uses, cash flow statement suffers from the following limitations:

(i) As cash flow statement is based on cash basis of accounting, it ignores the basic accounting concept of accrual basis.

(ii) Some people feel that as working capital is a wider concept of funds, a funds flow statement provides a more complete picture than cash statement.

(iii) Cash flow statement is not suitable for judging the profitability of a firm as non-cash changes are ignored while calculating cash flows from operating activities.

(iv) Cash Flow Statement gives the main items of inflow and outflow of cash only and does not show the liquidity position of the company.

(v) This statement is not a substitute of income statement which shows both cash and non-cash items. Therefore, net cash flow does not necessarily mean net income of the business.

(vi) It cannot replace funds flow statement as it cannot show the financial position of the concern in totality.

Q: Classify cash flows. *(www.prepnext.com)*

Ans:

According to AS-3 (Revised) the cash flow statement should report cash flows during the period classified by operating, investing and financing activities. Thus, cash flows are classified into three main categories:

1) Cash flows from operating activities
2) Cash flows from investing activities
3) Cash flows from financing activities

1) Cash Flows from Operating Activities:

Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

A few examples of cash flows from operating activities are:

(a) Cash receipts from the sale of goods and the rendering of services;
(b) Cash receipts from royalties, fees, commissions, and other revenue;
(c) Cash payment to suppliers of goods and services;
(d) Cash payments to and on behalf of employees
(e) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities.

2) Cash Flows from Investing Activities:

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

A few examples of cash flows arising from investing activities are:

(a) Cash payments to acquire fixed assets (including intangibles)
(b) Cash receipts from disposal of fixed assets (including intangibles)
(c) Cash payments to acquire shares, warrants or debt instruments of other enterprises (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
(d) Cash receipts from disposal of shares, warrants or debt instruments of other enterprises (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);
(e) Cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
(f) Cash receipts from the repayment of advances and loans made to third parties (other than advances and loans made by a financial enterprise);

3) Cash Flows from Financing Activities:

Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

A few examples of cash flows arising from financing activities are:

(a) Cash proceeds from issuing of shares or other similar instruments;
(b) Cash proceeds from issuing debentures, loans, notes, bonds and other short- or long –term borrowings; and
(c) Cash repayments of amounts borrowed such as redemption of debentures, bonds, preference shares.
(d) Payment of Dividend

Q: Explain the treatment of the following items in a cash flow statement.

i) Interest and Dividends **ii)** Extraordinary items

(www.prepnext.com)

Ans:

i) <u>Interest and Dividends</u>

Cash flows from interest and dividends received and paid should be disclosed separately. The treatment of interest and dividends received and paid depends upon the nature of the enterprise. For this purpose, the enterprises are classified as (i) financial enterprises, and (ii) other enterprises.

(a) Financial Enterprises.

In the case of financial enterprises, cash flows arising from interest paid and interest and dividends received should be classified as cash flows arising from operating activities. **Dividends paid** should be classified as cash flows from financing activities.

(b) Other Enterprises.

In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. **Dividends paid** should be classified as cash flows from financing activities.

ii) <u>Extraordinary Items:</u>

The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed in the cash flow statement to enable users to understand their nature and effect on the present and future cash flows of the enterprise.

Q: Differentiate between cash flow statement and funds flow statement. *(www.prepnext.com)*

Ans:
A cash flow statement is much similar to a funds flow statement as both are prepared to summarise the causes of changes in the financial position of a business. However, following are the main differences between a funds and a cash flow statement.

Basis	Funds Flow Statement	Cash Flow Statement
Basis of Concept	It is based on a wider concept of funds, i.e., working capital	It is based on a narrower concept of funds, i.e., cash (and cash equivalents) only, which is only one element of working capital.
Basis of Accounting	It is based on accrual basis of accounting.	It is based on cash basis of accounting.
Schedule of Changes in Working Capital	Schedule of changes in working capital is prepared to show the changes in current assets and current liabilities.	No such schedule of changes in working capital is prepared.
Method of Preparing	Fund Flow Statement reveals the sources and applications of funds. The net difference between sources and applications of funds represents net increase or decrease in working capital.	It is prepared by classifying all cash inflows and outflows in terms of operating, investing and financing activities. The net difference represents the net increase or decrease in cash and cash equivalents.
Period of Planning	It is useful in planning intermediate and long term financing.	It is more useful for short-term analysis and cash planning of the business.
Object	The object of funds flow is to disclose the magnitude, direction and causes of changes in working capital of which cash is one of the elements.	The object of cash flow is to disclose the magnitude, direction and causes of changes in cash and cash equivalents.

Useful for short term planning	Funds flow statement is comparatively less useful.	Cash flow statement is more useful to the management as a tool of financial planning and analysis in short periods.
Inflow	Inflow of funds does not necessarily mean inflow of cash	Whenever there is inflow of cash, there will definitely be inflow of funds.
Format	No proforma is prescribed for the preparation of funds flow statement.	Cash flow statement is compulsorily to be prepared in prescribed proforma as given in AS - 3
Division of activities	No division of activities is specified for the preparation of funds flow statement.	The preparation of cash flow statement is divided into three parts i.e, cash flows from operating activities, investing activities and financing activities before making adjustments for cash and cash equivalent at the beginning and end of the period.
Preparation	*Funds flow statement can be prepared from the cash flow statement under indirect method.*	*A cash flow statement cannot be prepared from funds flow statement*