

CASH FLOW STATEMENT

Meaning, Objectives, Importance and Limitations of Cash Flow Statement:

- **Meaning of Cash Flow and Cash Flow Statement:**
 - **Cash Flow:** A cash flow is the inflow (receipt) and the outflow (payment) of Cash and Cash equivalents, where cash and cash equivalents include Cash, Bank Balance, Marketable Securities, etc. (unless specified otherwise, Current Investments are considered as Marketable Securities).
 - **Cash Flow Statement:** It is a statement that shows the inflows and the outflows of Cash and Cash Equivalents during the period. Inflows are those transactions that increase the Cash and Cash Equivalents and outflows are those transactions that decrease the Cash and Cash Equivalents. Such statement is prepared in accordance with the Accounting Standard-3 (Revised) on Cash Flow Statement. As per this accounting standard, cash flows are shown under the following 3 heads:
 - Cash Flow from Operating Activities;
 - Cash Flow from Investing Activities; and
 - Cash Flow from Financing Activities.

- **Cash Flow from Operating Activities:** Activities related to core or principal revenue generating activities of an enterprise.
Cash Inflows:
 - i. from Cash Sales
 - ii. from Debtors
 - iii. as Commission and RoyaltyCash Outflows:
 - i. Cash Purchases
 - ii. Payment to creditors
 - iii. Payment of wages

- **Cash Flow from Investing Activities:** Activities related to sale and purchase of long-term fixed assets and investments.
Cash Inflows:
 - i. Proceeds from sale of Fixed Assets and Investments
 - ii. Interest and dividend receivedCash Outflows:
 - i. Purchase of long-term fixed assets such as Land & Building, Plant & Machinery, Investments, etc.

- **Cash Flow from Financing Activities:** Activities related to capital or long-term funds of an enterprise.
Cash Inflows:
 - i. Proceeds from Issue of Shares and Debentures for Cash
 - ii. Proceeds from Long-term Borrowings such as Bonds, Loans, etc. CashOutflows:
 - i. Repayment of Loans
 - ii. Redemption of Preference Shares and Debentures
 - iii. Buy-back of Equity Shares
 - iv. Payment of Dividend and Interest, etc.

- **Objectives of Cash Flow Statement:** A Cash Flow Statement is prepared:
 - i. to determine the sources of Cash and Cash Equivalents under operating, investing and financing activities of the enterprise.
 - ii. to determine the applications of Cash and Cash Equivalents for operating, investing and financing activities of the enterprise.
 - iii. to determine the net change in Cash and Cash Equivalents due to cash inflows and outflows for operating, investing and financing activities of the enterprise that take place between the 2 balance sheet dates.

- **Importance or Uses of Cash Flow Statement:** Preparation of Cash Flow Statement is helpful for following reasons:
 - i. **To facilitate Short-term Planning:** It helps in planning investments and assessing the financial requirements of the enterprise based on information provided in the statement about the sources and applications of Cash and Cash Equivalents.
 - ii. **To assess Liquidity and Solvency:** It helps in identifying the ability of the enterprise to meet its liabilities on time.
 - iii. **To manage Cash Efficiently:** It provides information about the cash position by reflecting either a surplus of cash or a deficit of cash in the statement. This helps the enterprise to take decisions about the investment of surplus cash and the arrangement of deficit funds.
 - iv. **To facilitate Comparative Study:** It facilitates the comparison of actual cash flows with the budgeted cash flows to identify whether the inflows and outflows of cash are moving as per the plan. Such comparison will also reflect deviations of the actual cash flows from the budgeted cash flows for which necessary actions are then taken by the enterprise.
 - v. **To justify Cash Position:** Cash flow statement is prepared to record all the cash inflows and outflows which result in the surplus or deficit of cash for an enterprise. Since, all the cash transactions are presented in the statement, it becomes easy to identify the items which increase or decrease the cash balances.
 - vi. **To evaluate Management Decisions:** This statement classifies the cash transactions under 3 separate heads namely, operating, investing and financing. Such classification helps the users of the statement to evaluate whether the decisions taken by the management are appropriate from investing and financing point of view.
 - vii. **To take dividend decisions:** In order to declare or approve the dividends, every enterprise should comply with the prescribed provisions e.g. depositing the amount of dividend in a separate bank, etc. Accordingly, to identify whether the enterprise has sufficient funds for such compliance cash flow statement is referred by the management. Also, it helps in deciding how much dividend the enterprise should pay during a particular year.

- **Limitations of Cash Flow Statement:**
 - i. **Non-cash transactions are not shown:** It takes into consideration only cash inflows and cash outflows. Non-cash transactions are not considered for preparation of cash flow statement.
 - ii. **Not a substitute for an Income Statement:** Cash flow statement cannot be used as a substitute for an Income Statement because Income Statement is prepared on accrual basis of accounting whereas cash flow statement is prepared on cash basis. Also, it is not possible to compute net profit or loss from the cash flow statement.
 - iii. **Not a substitute for Balance Sheet:** Cash flow statements do not show the financial position of the enterprise and therefore, cannot be used as a substitute for Balance Sheet.
 - iv. **Historical in Nature:** Cash flow statement is prepared based on the cash inflows and outflows that have already taken place during the year and hence, it is historical in nature.
 - v. **Assessment of Liquidity:** Cash flow statement takes into consideration all the transactions of cash

and cash equivalents. This cash and cash equivalents are just one of the components in the current assets which determine the liquidity position of the enterprise. Therefore, cash flow statement alone cannot help in determining the liquidity position of the enterprise.

- vi. **Accuracy of Cash Flow Statement:** Since, the cash flow statement is prepared from the financial statements of an enterprise; accuracy of the same shall depend upon how accurately the financial statements of the enterprise are prepared.

Terms used in Cash Flow Statement

Definition of Key Terms used in Cash Flow Statement:

- **Cash and Cash Equivalents:**
 - **Cash:** It includes Cash in hand and demand deposits with banks.
 - **Cash Equivalents:** It includes highly liquid short-term investments that are readily convertible into cash and that are subject to an insignificant risk of change in value. It includes treasury bills, commercial papers, current investments and preference shares if these are redeemable **within 3 months from the date of purchase** and if they do not have any significant risk of change in its value.
 - **Disclosure in Cash Flow Statement:**

Cash and Cash Equivalent is calculated as:

Cash in Hand	...
<i>Add:</i> Cash at Bank	...
<i>Add:</i> Cheques and Drafts on Hand	...
<i>Add:</i> Short-term Investments (Marketable Securities)	...
<i>Add:</i> Short-term Deposits in Banks	...
Cash and Cash Equivalents	...

Classification of Cash Flows for Cash Flow Statement

- **Classification of Cash Flows as per Accounting Standard-3 (Revised):** This standard on Cash Flow Statement requires that all the inflows and outflows of the cash and cash equivalent during a particular period should be classified under 3 different heads as per the nature of transactions. These 3 heads are explained as follows:
 - i. **Operating Activities:** These are the principal revenue generating activities of an entity. It includes all non-investing and non-financing activities. In a cash flow statement, net effect of all the inflows and outflows from operating activities is shown as Cash Flow from (or used in) Operating Activities. Following is the list of operating activities for:
 - **Financial Companies:** It includes all transactions related to:
 - a. purchase of securities;
 - b. sale of securities;
 - c. interest on loans granted;
 - d. interest on loans taken;
 - e. dividends on securities;
 - f. salaries, bonus and other employee benefits paid to employees;
 - g. Income tax paid and income tax refund received (unless such amounts are identified with investing or financing activities).

- **Non-Financial Companies:** It includes all transactions related to:
 - a. purchase of goods and/or availing of services;
 - b. sale of goods and/or rendering of services;
 - c. amounts received from trade receivables;
 - d. amounts paid to trade payables;
 - e. royalties, fees and commission, etc.;
 - f. wages, salaries and other employee benefits paid to the workers and employees;
 - g. payment of claims and receipt of premium (in case of Insurance Companies)
 - h. Income tax paid and income tax refund received (unless such amounts are identified with investing or financing activities).

ii. Investing Activities: These include all activities related to the acquisition and disposal of Long-term Assets and other investments which are not classified as cash equivalents. Following is the list of investing activities:

- a. purchase of fixed assets;
- b. sale or disposal of fixed assets;
- c. purchase of securities (in case of non-financial companies);
- d. sale of securities (in case of non-financial companies);
- e. loans and advances made to third parties (other than those made by a financial enterprise)
- f. repayments received from loans and advances made to third parties (other than those made by a financial enterprise)

iii. Financing Activities: These are those activities that change the size and composition of the owner's capital (i.e., Equity and Preference Share Capital in case of a company) and borrowings of the enterprise.

Following is the list of financing activities:

- a. issue of shares or other similar instruments;
- b. issue of debentures, loans, bonds, and other short-term borrowings;
- c. changes in bank overdraft and cash credit;
- d. buy-back of equity shares;
- e. repayment of borrowings including redemption of debentures;
- f. dividends on both equity and preference shares;
- g. Interest on debentures and loans (both short and long-term loans).

• **Transactions not regarded as Cash Flow:** These are the transactions that are mere movements in between the items of Cash and Cash Equivalents. This includes cash deposited in bank, cash withdrawn from the bank and purchase or sale of marketable securities.

• **Non-cash transactions:** These are the transactions in which the inflow or outflow of Cash or Cash Equivalent does not take place. Therefore, these non-cash transactions are not considered while preparing the Cash Flow Statements. These transactions include depreciation, amortization, issue of bonus, etc.

• **Types of Businesses and Impact on Cash Flow:**

Financial Enterprise: An enterprise that basically deals in *lending* (advancing loans) and *borrowing* of funds (accepting deposits), such as Banks.

Non-Financial Enterprise: An enterprise that basically deals in areas other than finance (purchase of raw material and sale of goods).

For an activity to be classified as 'Operating' or 'not' focus, Nature of Business is guiding factor, i.e. Core Business Activity of the business.

Classification of Lending and Borrowing Functions				
Function	Advancing Loans		Accepting Deposits from Public	
<i>Business Activity</i>	Interest Received	Dividend Received	Interest Paid	Dividend Paid
Trading or Non-Financial Enterprise	Investing Activity	Investing Activity	Financing Activity	Financing Activity
Financial Enterprise	Operating Activity	Operating Activity	Operating Activity	Financing Activity

Paid on capital raised from External sources ←

- **Importance of separate disclosure of cash flows under each activity:**
 - **Operating Activities:**
 - It acts an indicator of the extent to which the business operations successfully generate cash.
 - It determines operating efficiency of the entity.
 - It helps in taking vital decisions with respect to use of cash for payment of dividends to shareholders, make new investments, expand projects, etc.
 - It helps in forecasting and projecting future cash flows.
 - **Investing Activities:**
 - It represents the extent to which expenditure has been incurred to generate future revenue and cash flows.
 - **Financing Activities:**
 - It assists in assessing claims on future cash flows by contributors of funds to the enterprise.
- **Format of Cash Flow Statement:**



Cash Flow Statement for the year ended xxxx

Particulars	Details	Amount
I. Cash Flow from Operating Activities		
(A) Net Profit before Taxation and Extraordinary Items		-
Adjustment for Non-cash and Non-operating Items		
(B) Add: Items to be Added		
(C) Less: Items to be Deducted		
(D) Operating Profit before Working Capital changes (A + B - C)		...
(E) Add: ↓ in CA and ↑ in CL		
(F) Less: ↑ in CA and ↓ in CL		
(G) Cash generated from Operations (D + E - F)		...
Less: Income Tax Paid (Net of Tax Refund received)		(...)
Cash Flow before Extraordinary Items		
Extraordinary Items (+/-)		...
(H) Net Cash from (or used in) Operating Activities		...
II. Cash Flow from Investing Activities		
Proceeds from Sale of Fixed Assets		...
Purchase of Fixed/Intangible Assets		(...)
Extraordinary Items (+/-)		...
(I) Net Cash from (or used in) Investing Activities		...
III. Cash Flow from Financing Activities		
Proceeds from Issue of Shares or Debentures		...
Proceeds from Other Long-term Borrowings		...
Repayment of Loan		(...)
Redemption of Shares or Debentures		(...)
Bank Overdraft		...
Extraordinary Items (+/-)		...
(J) Net Cash from (or used in) Financing Activities		...
IV. Net ↑/↓ in Cash & Cash Equivalents (I + II + III)		...
Add: Cash & Cash Equivalents in the beginning of the year		...
V. Cash & Cash Equivalents at the end of the year		...

- **Extraordinary Items:**

- All the incomes and expenses that arise from events or transactions that are clearly distinct from the ordinary course of business of the enterprise are termed as extraordinary items.
- All such items are not expected to recur frequently or regularly.
- It includes items such as payment to shareholders in the event of buy back of shares, claim for damages received, etc.

Cash Flow from Operating Activities

- **Cash Flow from Operating Activities:** Following are the steps to be followed under indirect method:
 - **Indirect Method:** In this method, Cash Flow from Operating Activity is calculated from statement of Profit and Loss and Balance Sheet with the help of following steps:
 - **Step 1:** Calculate the Net Profit before Tax and Extraordinary Items.
 - **Step 2:** Calculate the Operating Profit before Working Capital Changes.
 - **Step 3:** Compute the Cash generated from Operating Activities.
 - **Step 4:** Compute the Cash flow from Operating Activities before Extraordinary Items.
 - **Step 5:** Compute the Cash flow from (or used in) Operating Activity.

- Steps to Ascertain Net Profit before Tax and Extraordinary Items

Steps to Prepare Cash Flow Statement (from Operating Activities)	
Ascertain Net Profit before Taxation & Extraordinary Items	
Difference b/w Closing Balance & Opening Balance of P&L A/c	
Add:	Transfer to reserve (In case of increase)
	Proposed dividend for CY
	Interim dividend paid during the year
	Prov. for tax made during the CY
	Extraordinary item, if any, debited to the P&L A/c
Less:	Extraordinary item, if any, credited to the P&L A/c
	Decrease in reserve
	Refund of tax credited to P&L A/c
Net Profit before Taxation & Extraordinary Items	

- Steps to Ascertain Operating Profit Before Working Capital Changes

Steps to Prepare Cash Flow Statement (from Operating Activities)	
Ascertain Operating Profit before Working Capital Changes	
Net Profit before Taxation & Extraordinary Items	
Add:	Depreciation
	Preliminary Expenses/Discount on issue of Debentures (written off)
	Goodwill/Patents/Trademarks <u>amortised</u>
	Interest on Borrowings and Debentures
	Loss on sale of Fixed Assets
Less:	Interest/Dividend/Rent received
	Profit on sale of Fixed Assets
Operating Profit before Working Capital Changes	

- Ascertaining Cash Generated from Operations

Steps to Prepare Cash Flow Statement (from Operating Activities)	
Ascertain Cash generated from Operations	
Operating Profit before Working Capital Changes	
Add:	↓ in CA and ↑ in CL
	Decrease in Stock/Trade Receivables, etc.
	Increase in Bills Payable/Creditors, etc.
Less:	↑ in CA and ↓ in CL
	Increase in Stock/Trade Receivables, etc.
	Decrease in Bills Payable/Creditors, etc.
Cash generated from Operations	

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Cash Flow from Investing Activities

- **Cash Flow from Investing Activities:**

- These include all activities related to the acquisition and disposal of Long-term Assets and other investments which are not classified as cash equivalents.
- All cash inflows and outflows relating to the fixed assets, shares and related instruments of other enterprise including loans and advances to third parties and their repayments are classified under Investing Activities.
- It shows the extent to which investments have been made for resources that generate revenue and cash flows in future.
- It is determined by analysing the changes in fixed assets, long-term investments in the beginning and at the end of the year for which specific accounts can be prepared using the values that are available.

Steps to Prepare Cash Flow Statement (from Investing Activities)

1. Ascertain *Cash inflows* from Investing Activities

- Proceeds from Sale of Fixed Assets
- Proceeds from Sale of Investments
- Interest and Dividend received (Non-Financial Company)
- Rent Income

2. Ascertain *Cash outflows* from Investing Activities

- Purchase of Fixed Assets
- Purchase of Investments
- Purchase of Intangible Assets like Goodwill

Cash Flow from Financing Activities

- **Cash Flow from Financing Activities:**

- These are those activities that change the size and composition of the owner's capital (i.e., Equity and Preference Share Capital in case of a company) and borrowings of the enterprise.
- It is useful in estimating claims on cash flows by lenders of funds in future and therefore, are shown separately.
- It is computed by analysing change in Equity and Preference Share Capital, Debentures and other borrowings. It also takes into consideration the amounts paid on account of interest (only in case of non-financing companies) and dividend (all types of companies).
- If shares or debentures are issued at a premium, Cash Flow Statement shows total cash received from the issue that includes both nominal value and the premium.
- Any amount of share issue expenses and underwriting commission is a cash outflow from financing activities.
- It does not take into consideration bonus issue as it is just a capitalisation of reserves for which the company does not receive any cash for it. Similarly, conversion of debentures into new debentures or shares involves no cash flow and therefore not considered in a cash flow statement.

Steps to Prepare Cash Flow Statement (from Financing Activities)**Net Cash from (or used in) Financing Activities**

1. Compute **Cash inflows** from Financing Activities
 - Proceeds from Issue of Securities
 - Proceeds from Long-term Borrowings
 - Increase in Bank Overdraft & Cash Credit
2. Compute **Cash outflows** from Financing Activities
 - Repayment of Loan
 - Redemption of Pref. shares or Debentures
 - Dividend Paid
 - Interest on Debentures Paid
 - Decrease in Bank Overdraft & Cash Credit

Extraordinary Items

- + *Items* → **Cash Inflows** due to financing activities
- - *Items* → **Cash Outflows** due to financing activities

Treatment of Special Adjustments

- **Bank Overdraft:** Treated as short-term borrowings shown under Financing Activities

Accounting Treatment

- (i) Increase in Bank O/D - Cash Inflows
→ Added under Financing Activity
- (ii) Decrease in Bank O/D - Cash Outflows
→ Deducted under Financing Activity

- **Proposed Dividend:**

Accounting Treatment

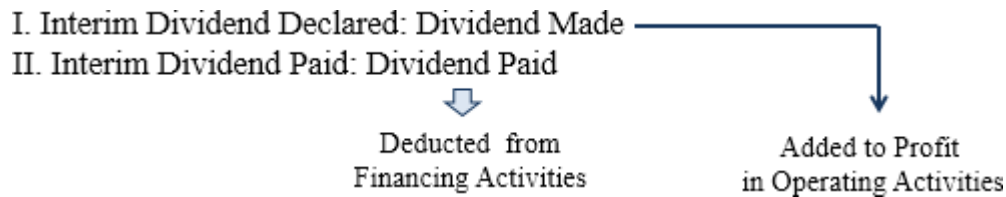
- (i) **Dividend Made (CY) → Added in Operating Activities**
- (ii) **Dividend Paid (PY) → Deducted from Financing Activities**

Proposed Dividend Account

Particulars	Amt	Particulars	Amt
Bank A/c (<i>Bal. Fig.- Dividend Paid</i>)		Balance b/d (PY's Bal.)	
Balance c/d (CY's Bal.)		Profit & Loss A/c (Dividend <i>Made</i>)	

- **Interim Dividend:** The dividend declared and paid by the Board of Directors before its Annual General Meeting during the current year. (*Always given as adjustment and is not affected by Proposed Dividend*).

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- **Income Tax Refund:** Deducted from Profits in Operating Activities and Deducted from Income Tax Paid.
- **Discount Written-off:** Added back to Current Year's Profits in Operating Activities
- **Discount Allowed During the Year:** Net Proceeds (after discount) shown as Cash from Financing Activities
- **Provision for Tax:**

Accounting Treatment			
(i) Taxes Made (CY) → Added to Profit in Operating Activities			
(ii) Taxes Paid (PY) → Deducted from Operating Activities			
Provision for Tax Account			
Particulars	Amt	Particulars	Amt
Bank A/c (<i>Bal. Fig.- Tax Paid</i>)		Balance b/d (PY's Bal.)	
Balance c/d (CY's Bal.)		Profit & Loss A/c (<i>Tax Made</i>)	

CY Balance	PY Balance	Related Adjustment	Treatment
Given	Given	No	CY Balance → Add to Profit in Operating Activities PY Balance → Deduct from Operating Activities
No	Given	No	PY Balance → Deduct from Operating Activities
Given	No	No	CY Balance → Add to Profit in Operating Activities
No	No	Taxes Paid Given	Taxes Paid → Deduct from Operating Activities
Given	Given	Given	Through Account

- **Fixed Asset Account:**
 - If assets are shown at their Written Down Value i.e. after providing depreciation:

Account prepared: Fixed Assets A/c

Fixed Assets Account			
Dr.	Particulars	Amt	Cr.
	Bal. b/d	xxx	Dep. A/c (<i>Charged during the year</i>)
	P&L A/c (Profit)	xxx	P&L A/c (Loss)
	Bank A/c (Purchase)	xxx	Bank A/c (Sale)
			Bal. c/d
			xxx

Accounting Treatment

a) Operating Activities

Add. Depreciation charged during the year

Subtract. Profit on Sale of Asset

Add. Loss on Sale of Asset

b) Investing Activities

Subtract. Purchase of Fixed Assets

Add. Sale of Fixed Asset

(ii) If assets are shown at their Original Value:

Accounts prepared: Fixed Assets A/c, and
Accumulated Depreciation A/c

Dr. Fixed Assets Account		Cr.	
Particulars	Amt	Particulars	Amt
Bal. b/d	xxx	Dep. A/c (<i>on part of asset</i>)*	xxx
P&L A/c (Profit)	xxx	P&L A/c (Loss)	xxx
Bank A/c (Purchase)	xxx	Bank A/c (Sale)	xxx
		Bal. c/d	xxx

Dr. Accumulated Depreciation Account		Cr.	
Particulars	Amt	Particulars	Amt
Fixed Assets A/c (<i>Dep. on part</i>)*	xxx	Bal. b/d	xxx
Bal. c/d	xxx	P&L A/c (<i>Dep. charged during the year</i>)	xxx

Accounting Treatment

a) Operating Activities

Add. Depreciation charged during the year

Subtract: Profit on Sale of Asset

Add. Loss on Sale of Asset

b) Investing Activities

Subtract: Purchase of Fixed Assets

Add. Sale of Fixed Asset

Preparation of Cash Flow Statement

Steps for Preparing Cash Flow Statement:

- **Step 1:** Compute cash flow from Operating Activities.
- **Step 2:** Compute cash flow from Investing Activities.
- **Step 3:** Compute cash flow from Financing Activities.
- **Step 4:** Adding Step 1, Step 2 and Step 3 above, compute the net increase or decrease in Cash and Cash Equivalents.
- **Step 5:** Amount computed in Step 4 is to be added to the balance of Cash and Cash Equivalents in the beginning of the year.
- **Step 6:** Adding Step 4 and Step 5 will give the balance of Cash and Cash Equivalents at the end of the year which will match the balance as per Balance Sheet.

Precautions to be taken for preparing Cash Flow Statement:

- **Balance in Statement of Profit and Loss:** Identify whether the balance in the Statement of Profit and Loss is positive or negative. When the opening balance is negative, it is to be added to the closing balance and when the opening balance is positive, it is to be deducted from the closing balance.
- **Balance of Other Reserves:** Identify whether the balances of other reserves have increased or decreased. When the increase is due to appropriation from Surplus, i.e., Balance in Statement of Profit and Loss, it is to be added to compute Net Profit before tax and Extraordinary Items.
- **Interest on borrowings:** Identify if the percentage of interest on borrowings is given and add the amount of interest paid to compute Net Profit before Working Capital Changes and show it as an 'Outflow' under Cash Flow from Financing Activities.

- **Interest on Investment:** Identify if the percentage of interest on Investment is given and deduct the amount of interest received to compute Net Profit before Working Capital Changes and show it as an 'Inflow' under cash Flow from Investing Activities
- **Non-cash Expenses:** Identify if non-cash expenses are given and add them to compute Net Profit before Working Capital Changes.
- **Non-operating Expenses:** Identify if non-operating expenses are given and add them to compute Net Profit before Working Capital Changes. It will be shown as an outflow under appropriate head.
- **Non-operating Incomes:** Identify if non-operating incomes are given and deduct them to compute Net Profit before Working Capital Changes.

