

CASH FLOW STATEMENT

The income statement focuses on the economic results of the entity's *operating* activities during a period. Key concepts in the measurement of the period's income are revenue recognition and the matching of expenses. Revenue is recognized in the period in which the entity performs its revenue-generating tasks (e.g., delivering goods or providing services), irrespective of whether the customer pays cash at that time or agrees to pay later. Expenses measure the resources consumed in generating the period's revenue and in administering the entity during the period, irrespective of when cash was used to pay for those resources. Thus, the period's income bears no direct relationship to the cash flows associated with the period's operations. Also, because of its focus on the results of operations, the income statement does not provide information about the entity's investing or financing activities during the period.

The purpose of the cash flow statement is to provide information about the *cash flows associated with the period's operations* and also about the entity's *investing and financing activities* during the period. This information is important both to shareholders, part of whose investment return (dividends) is dependent on cash flows, and also to lenders, whose interest payments and principal repayment require the use of cash. The welfare of other constituencies of a company—including its employees, its suppliers, and the local communities that may levy taxes on it—depends to varying degrees on the company's ability to generate adequate cash flows to fulfill its financial obligations.

The numbers on the cash flow statement are objective: *Cash is cash*, and the amounts of cash flows are not influenced by the judgments and estimates that are made in arriving at revenues, expenses, and other accruals. Because of this objectivity, many analysts pay considerable attention to the cash flow statement. It must be remembered that despite the judgments and estimates that influence balance sheet and income statement amount, the numbers in those statements provide better information about an entity's financial status and operating performance than do cash flow statement numbers.

A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

‘**Accounting Standard 3: Cash Flow Statement**’ discusses in detail the meaning and the method of preparation of Cash Flow Statement. This has been discussed next.

Definitions

The following terms are used in this Standard with the meanings specified:

- (a) *Cash* comprises cash on hand and demand deposits with banks.
- (b) *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.
- (c) *Cash flows* are inflows and outflows of cash and cash equivalents.
- (d) *Operating activities* are the principal revenue-producing activities of the enterprise

and other activities that are not investing or financing activities.

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

Cash and Cash Equivalents

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition.

Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Presentation of a Cash Flow Statement

The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

An enterprise presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

A single transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

Operating Activities

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss.

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 payments to suppliers for goods and services;
- (d) cash payments to and on behalf of employees;
- (e) cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- (f) cash payments or refunds of income taxes unless they can be specifically identified with

financing and investing activities; and

(g) cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

Investing Activities

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Examples of cash flows arising from investing activities are:

(a) cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;

(b) cash receipts from disposal of fixed assets (including intangibles);

(c) cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (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 and interests in joint ventures (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 of a financial enterprise);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

Financing Activities

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise.

Examples of cash flows arising from financing activities are:

(a) cash proceeds from issuing 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.

Reporting Cash Flows from Operating Activities

An enterprise should report cash flows from operating activities using either: (a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or (b) the indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

Direct Method

The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either: (a) from the accounting records of the enterprise; or (b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for: i) changes during the period in inventories and operating receivables and payables; ii) other non-cash items; and iii) other items for which the cash effects are investing or financing cash flows.

Indirect method

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of: (a) changes during the period in inventories and operating receivables and payables; (b) non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses; and (c) all other items for which the cash effects are investing or financing cash flows. Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Cash Flow Statement of X Ltd. for the year ended March 31, 20xx (Direct Method)

<i>Particulars</i>		
Operating Activities:		
Cash received from sale of goods	xxx	
Cash received from Trade receivables	xxx	
	xxx	xxx

Cash received from sale of services	xxx	
Less: Payment for Cash Purchases	xxx	
Payment to Trade payables	xxx	
Payment for Operating Expenses e.g. power, rent, electricity	xxx	
Payment for wages & salaries	xxx	xxx
Payment for Income Tax		xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		

Cash Flow Statement of X Ltd. for the year ended March 31, 20xx (Indirect Method)

<i>Particulars</i>		
Operating Activities:		
Closing balance of Profit & Loss Account	xxx	
Less: Opening balance of Profit & Loss Account	xxx	
	xxx	
Reversal of the effects of Profit & Loss Appropriation Account	xxx	
Add: Provision for Income Tax	xxx	
Effects of Extraordinary Items	xxx	
Net Profit Before Tax and Extraordinary Items	xxx	
Reversal of the effects of non-cash and non-operating items	xxx	
Effects for changes in Working Capital except cash & cash Equivalent	xxx	
	xxx	
Less : Payment of Income Tax	xxx	xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

Reporting Cash Flows from Investing and Financing Activities

An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities.

Interest and Dividends

Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. 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.

Taxes on Income

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate.

ILLUSTRATION 1

Classify the following activities as (a) Operating Activities, (b) Investing Activities, (c) Financing Activities (d) Cash Equivalents.

- a. Purchase of Machinery.
- b. Proceeds from issuance of equity share capital
- c. Cash Sales.
- d. Proceeds from long-term borrowings.
- e. Proceeds from Trade receivables.
- f. Cash receipts from Trade receivables.
- g. Trading Commission received.
- h. Purchase of investment.
- i. Redemption of Preference Shares.
- j. Cash Purchases.
- k. Proceeds from sale of investment
- l. Purchase of goodwill.
- m. Cash paid to suppliers.
- n. Interim Dividend paid on equity shares.
- o. Wages and salaries paid.
- p. Proceed from sale of patents.
- q. Interest received on debentures held as investment.
- r. Interest paid on Long-term borrowings.
- s. Office and Administration Expenses paid
- t. Manufacturing Overheads paid.
- u. Dividend received on shares held as investments.
- v. Rent Received on property held as investment.
- w. Selling and distribution expense paid.
- x. Income tax paid

- y. Dividend paid on Preference shares.
- z. Underwritings Commission paid.
- aa. Rent paid.
- bb. Brokerage paid on purchase of investments.
- cc. Bank Overdraft
- dd. Cash Credit
- ee. Short-term Deposits
- ff. Marketable Securities
- gg. Refund of Income Tax received.

Solution

Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.

Investing Activities: a, h, k, l, p, q, u, v, bb & ee.

Financing Activities: b, d, i, n, r, y, z, cc & dd.

Cash Equivalent: ff.

ILLUSTRATION 2

X Ltd. purchased debentures of Rs10 lacs of Y Ltd., which are redeemable within three months. How will you show this item as per AS 3 while preparing cash flow statement for the year ended on 31st March, 2017?

Answer

As per AS 3 on 'Cash flow Statement', cash and cash equivalents consists of cash in hand, balance with banks and short-term, highly liquid investments. If investment, of Rs10 lacs, made in debentures is for short-term period then it is an item of 'cash equivalents'. However,

if investment of Rs10 lacs made in debentures is for long-term period then as per AS 3, it should be shown as cash flow from investing activities.

ILLUSTRATION 3

Classify the following activities as per AS 3 Cash Flow Statement:

- a. Interest paid by financial enterprise
- b. Tax deducted at source on interest received from subsidiary company
- c. Deposit with Bank for a term of two years
- d. Insurance claim received towards loss of machinery by fire
- e. Bad debts written off

Solution

- a. Cash flows from operating activities
- b. Cash flows from investing activities
- c. Cash flows from investing activities
- d. Extraordinary item to be shown as a separate heading under 'Cash flow from investing activities'
- e. It is a non-cash item which is adjusted from net profit/loss under indirect method, to arrive at net cash flow from operating activity.

ILLUSTRATION 4

Following is the cash flow abstract of Alpha Ltd. for the year ended 31st March, 2017:

Cash Flow (Abstract)

Inflows	Rs	Outflows	Rs
Opening balance:		Payment for Account	
Cash	10,000	Payables	90,000
Bank	70,000	Salaries and wages	25,000
Share capital – shares issued	5,00,000	Payment of overheads	15,000
Collection on account of Trade Receivables	3,50,000	Fixed assets acquired	4,00,000
Sale of fixed assets	70,000	Debentures redeemed	50,000
		Bank loan repaid	2,50,000
		Taxation	55,000
		Dividends (including dividend distribution tax)	1,00,000
		Closing balance:	
		Cash	5,000
		bank	10,000
	10,00,000		10,00,000

Prepare Cash Flow Statement for the year ended 31st March, 2017 in accordance with Accounting standard 3.

Answer

Cash Flow Statement for the year ended 31.3.2017

	Rs	Rs
Cash flow from operating activities		
Cash received on account of trade receivables	3,50,000	
Cash paid on account of trade payables	(90,000)	
Cash paid to employees (salaries and wages)	(25,000)	
Other cash payments (overheads)	(15,000)	
Cash generated from operations	2,20,000	
Income tax paid	(55,000)	
Net cash generated from operating activities		1,65,000
Cash flow from investing activities	(4,00,000)	

Payment for purchase of fixed assets		
Proceeds from sale of fixed assets	70,000	
Net cash used in investment activities		(3,30,000)
Cash flow from financing activities		
Proceeds from issue of share capital	5,00,000	
Bank loan repaid	(2,50,000)	
Debentures redeemed	(50,000)	
Dividends paid	(1,00,000)	
Net cash used in financing activities		1,00,000
Net decrease in cash and cash equivalents		(65,000)
Cash and cash equivalents at the beginning of the year		80,000
Cash and cash equivalents at the end of the year		15,000

ILLUSTRATION 5

Prepare Cash Flow from Investing Activities of M/s. Creative Furnishings Limited for the year ended 31-3-2017.

Particulars	Rs
Plant acquired by the issue of 8% Debentures	1,56,000
Claim received for loss of plant in fire	49,600
Unsecured loans given to subsidiaries	4,85,000
Interest on loan received from subsidiary companies	82,500
Pre-acquisition dividend received on investment made	62,400
Debenture interest paid	1,16,000
Term loan repaid	4,25,000
Interest received on investment (TDS of Rs 8,200 was deducted on the above interest)	68,000
Book value of plant sold (loss incurred Rs 9,600)	84,000

Solution

**Cash Flow Statement from Investing Activities of
M/s Creative Furnishings Limited for the year ended 31-03-2017**

Cash generated from investing activities	Rs	Rs
Interest on loan received	82,500	

Pre-acquisition dividend received on investment made	62,400	
Unsecured loans given to subsidiaries	(4,85,000)	
Interest received on investments (gross value)	76,200	
TDS deducted on interest	(8,200)	
Sale of plant	74,400	
Cash used in investing activities (before extra ordinary item)		(1,97,700)
Extraordinary claim received for loss of plant		49,600
Net cash used in investing activities (after extra ordinary item)		(1,48,100)

Note:

1. Debenture interest paid and Term Loan repaid are financing activities and therefore not considered for preparing cash flow from investing activities.
2. Plant acquired by issue of 8% debentures does not amount to cash outflow, hence also not considered in the above cash flow statement.