B.Com.

Semester VI

DSC 6.1 A Fianancial Reporting & Financial Statement Analysis

Notes on

Cash Flow Statement

1. The purpose of financial reporting is to enable users to make decisions about the reporting entity. The traditional statements do not always give useful meaning regarding the operations of the enterprise. It was felt that the traditional statements should be supplemented by a fund flow statement to show the **way** an enterprise got its fund during the reported period and the **way** they were used.

2. However, fund flow statement suffers from a number of drawbacks. The concept of '**fund'** varies from one person to another person. Increase in net working capital **may** be sign of bad financial health, if the increase is due to accumulation of slow moving stock or due to customers failing to pay in time.

3. The disadvantages of the fund flow statement gave rise to cash flow statement. Such statement gives an indication of the relationship between profitability and cash generating ability and thus of the quality of the profit earned.

In particular, the aim of cash flow statement is should be to assist users:

- to assess the enterprise's ability to generate positive net cash flows in the future;
- to assess its ability to meet its obligation to service loans, pay dividends and so on;
- to assess the reasons for difference between reported profit and related cash flows;
- to assess the effect on its finances of major transactions during the year.

4. Why cash flow differs from net profit ?

The following principal reasons for the difference between two figures:

- Items which are cash flows but it is neither any income nor any expenses e.g. issue of shares, purchase of assets.
- Non-cash charges e.g. depreciation which are deducted from profit but it is not a cash flow.
- Expenses, which are deducted from profit whether or not paid, but cash flows to the extent of actual payment.
- Incomes, which are added to profit whether or not received, but cash flows to the extent of actual receipt.
- Opening stock, which is deducted from profit but not from cash flow.
- Closing stock which is added to profit but not to cash flow.

5. In a Cash flow statement, the cash flows are divided into **three parts**. They are:

a) Cash flow from **operating activities**;

b) Cash flow **from investing activities**;

c) Cash flow from **financing activities**.

There are **two** methods of preparing cash flow statement as it is prescribed by Ind AS-7 of ICAI. They are:

A] Direct method; B] Indirect method.

Only the pattern of **Cash flow from operating activities** change due the change of method. The other heads are indifferent to the change of method.

6. **Indirect method of Cash flow statement**

Cash flows from operating activities:

Net profit before taxation and extraordinary items

Adjustments for:

(+) Depreciation

(+) Foreign exchange loss

(-) Interest income

(-) Dividend income

(+) Interest expense

Operating profit before working capital changes

Less: Increase in current assets

Less: Decrease in current liabilities

Add: Decrease in current assets

Add: Increase in current liabilities

Cash generated from operations

Income taxes paid

Cash flow before extraordinary item

Proceeds from earthquake disaster settlement

Insurance claim received

Claim for damages received

Payment for VRS

Cash stolen

Net Cash flows from operating activities

Cash flows from investing activities :

Purchase of fixed assets

Proceeds from sale of equipment

Interest received

Dividends received

Net cash flow from investing activities

Cash flows from financing activities:

Proceeds from issuance of share capital

Proceeds from long-term borrowings

Repayment of long-term borrowings

Interest paid

Net cash flow from financing activities

Net increase/ decrease in Cash and cash equivalents

Cash and cash equivalents at beginning of period (see Note)

Cash and cash equivalents at end of period (see Note)

Direct Method Cash Flow Statement

Cash flows from operating activities:

Cash receipts from customers

Cash paid to suppliers and employees

Cash generated from operations

Income taxes paid

Cash flow before extraordinary item

Proceeds from earthquake disaster settlement

Net cash from operating activities

Notes:

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money-market instruments.

7. 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:

cash receipts from the sale of goods and the rendering of services;

cash receipts from royalties, fees, commissions and other revenue;

cash payments to suppliers for goods and services;

cash payments to and on behalf of employees;

cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;

cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities.

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from **investing activities**.

An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by **financial enterprises** are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

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**:

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

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

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);

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);

cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);

cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);

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:

cash proceeds from issuing shares or other similar instruments;

cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and

cash repayments of amounts borrowed.

8.Treatment of interest and dividend:

Cash flow from interest and dividend received and paid should be disclosed separately.

Special Points	**Financial Company**	**Other Company**
Interest/Dividend Received	Operating activities	Investing activities
Interest paid	Operating activities	Financing activities

Dividend paid in **all cases** should be classified as cash flows from financing activities.