

Unit – III

Lesson 7

FUND FLOW: AN INTRODUCTION

Objective:

- To familiarize the students with concept of fund flow.
- To explain difference between fund flow and income statement.

Structure:

- Introduction
- Meaning of Fund flow
- Significance
- Difference between fund flow & income statement
- Summary
- Self Check Questions

Introduction:

Fund flow statement was initiated in the name of '**Where-got and where-gone statement**'. Few years later the heading was changed to '**Fund Statement**'. On the basis of studies carried out of American Institute of Certified Public Accountants (AICPA) in 1961, **Accounting Principle Board** proposed the new name '**Sources**' and **Application of Funds**' for Fund Flow Statement. In 1971, Accounting Principle Board made it mandatory to prepare Fund Flow Statement and also to attach it with financial statements, along with the Board proposed to name this statement as '**Statement of Changes in Financial Position**'. According to proposal number 19 of Board, to fulfill the condition of International Accounting Standard, Statement of changes in financial position is divided into two parts:

- (i) Statement of changes in the working capital (Fund Flow Statement)
- (ii) Statement of changes in cash (cash flow statement)

MEANING OF FUND FLOW STATEMENT

Fund Flow Statement Comprises of two words:

Fund and Flow. Following is the meaning of these two words.

Meaning of Funds: In narrow sense, the word fund is synonymous to Cash. In this sense fund statement is a description of Cash receipts and Cash payments which is known as Cash Flow Statement. In broad sense the word fund refers to working Capital which is also known by the name of free or Net Current Assets. The difference between Current Assets and Current Liabilities is known as working capital.

As Formula: $\text{Current Assets} - \text{Current Liabilities} = \text{Working Capital}$

To describe the meaning of fund, following is the clarification of words Current Assets, Current Liabilities and Non-Current Liabilities.

Meaning of Current Assets: Current Assets refers to Cash and those assets which can be converted into cash within one year (within one accounting period). Generally current assets change their form within one accounting period: For example –

Stock is converted into debtors, Debtors are converted into Bills Receivable or Cash.

Items Included in current Assets:

Cash in hand, cash at bank, bills receivable, sundry debtors, short term loan, temporary or short term investment, prepaid expenses, accrued income, stock or inventories of work-in-progress, finished goods and raw materials, advance payment, marketable securities etc.

Meaning of Current Liabilities:

Liabilities which are paid within one accounting period through temporary assets or by creation of new liabilities are known as current liabilities.

Items Included in Current Liabilities:

Creditors, bills payable, bank overdraft, outstanding expenses, unearned income, tax payable, short term loan, dividend payable, provision against current assets, provision for taxations, amount received in advance etc.

Important Point: Provisions related to Current assets can be deducted out of concerned current assets also:

Non-Current Liabilities or Fixed Liabilities:**Capital and Reserves:**

Liabilities for which payment has to be made after one year, or after a long period or after closure of business are included in Non-Current liabilities. Following are included in Non Current Liabilities: Equity Share Capital and Preference Share Capital, Security Premium, Capital Reserve, Capital Redemption Reserve, General Reserve, Sinking Fund. P & L account, Insurance Fund, Compensation Fund, Investment Fluctuation Reserve, Bonds, Dividend Equalization. Reserve, Provision for Depreciation or Depreciation fund against fixed assets, Debentures, Long term Loans, Proposed Dividend and Provisions for Income Tax. (If they are not treated as current liabilities), etc.

Non Current Assets or Fixed Assets:

Non-Current Assets refers to those assets which are purchased for profit generation (Not for resale) for long period. Profit is generated from such assets for long period. Intangible and artificial assets are also kept under this category. Following are the items of Non-current assets : Goodwill, Land & Building, Plant and Machinery, Furniture, Patents, Trade Marks, Copyrights, Long Term Investment, Preliminary Expenses, Debit balance of P & L account. Discount on Issue of Shares and Debentures, Advertisement Expenses and Underwriting Commission etc.

Meaning of Flow:

Flow refers of change thus, flow means changes in working capital, it refers to increase or decrease in net working capital. If working capital is affected by any transaction then it is treated as flow of fund and in contrary to this if working capital remains unaffected with any transaction, it is not treated as flow of fund. If, as a result of any transaction, working Capital increases, it is known as 'Source of Fund' and if working capital decreases, it is known as application of funds.

Meaning of Fund Flow Statement:

The statement prepared to study changes in funds of any business/organisation/enterprise in statement of affairs (balance sheet) between two accounting years is known as fund flow statement. This statement clarifies that through which sources and in what quantity funds have been provided to business between two statements of affairs and in what items these funds have been put to use.

Definition of Fund Flow Statement:

Following are the main definitions of Fund Flow Statement:

- (1) "The funds flow statement is a method by which we study the net funds flow between two points in time." - James C. Van Horne
- (2) "A statement of sources and applications of funds is a technical device designed to analyse the changes in the financial condition of a business enterprise between two

dates,"

- Plulke

Ideal Definition:

"Fund flow statement is a technical method with the help of which changes in financial condition of an organisation, between two financial balance sheets are studied.

Significance

Study of fund flow is important for Managers Investors, Banker, Shareholders, Creditors etc. Advantages of fund flow are given in the following points:

(1) For Financial Management:

(i) Helpful in financial analysis : Fund flow statement is an important tool for financial analysis. This statement provides information to finance manager about the sources and utilization of working capital in past accounting years.

(ii) Comparative Study is possible: With the help of fund flow statement it becomes possible to compare the balance sheet and P & L account of past years along with this, other informations which were not available through balance sheet and P & L account are also obtained.

(iii) Helpful in financial planning: With the analysis of fund flow statement, Finance manager is able to collect information about various facts which is helpful in preparing future financial plans and with this an organization can make provisions for finance efficiently.

(iv) Helpful in determining dividend policy: Number of times it is not possible to distribute dividend, keeping in view the liquidity of the organization. In such condition fund flow statement helps manager in deciding, whether the dividend should be distributed or not and if all dividend has to be distributed then what amount?

In relation to above mentioned facts, fund flow statement tells that how much funds are

required for distribution of dividend and from which sources these are to be arranged.

(v) Effective use and management of working capital: Finance manager is able to generate information about effective use of working capital, with the help of fund flow statement. This statement also provides information about excess or deficiency (insufficiency) of working capital.

(vi) Helpful in borrowing operations: Fund flow statement is helpful in procuring loans, as with the help of this statement the organization which is lending money is able to secure information regarding whether organization will have sufficient funds to pay all the interest and principal amount or not.

(2) Importance for shareholders: Shareholders are able to get answers to following questions with the study and analysis of fund flow statement:

- (i) Is their investment in organization secured?
- (ii) Whether dividend has been distributed from the profits generated or from other sources?
- (iii) Why organization is not paying dividend with higher rates despite of earning sufficient profits or why it is not distributing dividends?
- (iv) What is the dependence of organization on external debts?
- (v) What is the condition of working capital of an organization? (Excess, deficiency or sufficiency of working capital).

(3) Advantages to Creditors: With the help of fund flow statement creditors are able to generate information regarding whether organization will be able to repay their loans and interest or not and whether loan given by them is secured or not?

**DIFFERENCE BETWEEN FUND FLOW STATEMENT AND PROFIT AND LOSS ACCOUNT
(INCOME STATEMENT)**

S. No.	Basis of Difference	Fund Flow Statement	P & L Account or Income Statement
1.	Nature	In fund flow statement, revenue and capital items of both the nature are shown.	Items of revenue nature are only shown in P & L account.
2.	Objective	Objective of fund flow statement is to match the sources and uses of funds.	Objective of preparation of P & L account is to ascertain net profit or net loss arising out of business activities.
3.	Subject Matter	Fund flow statement depicts the sources and uses of finances for business activities.	P & L account depicts the results of business activities.
4.	Complimentary form	Fund flow is complementary of P & L account, it means it is based on P & L account.	P & L account is not based on fund flow statement.
5.	Proforma	No definite proforma has been specified for fund flow statement. It can be prepared in form of statement or account.	A definite proforma has been specified for P & L account and it is prepared according to it only.
6.	Period	It is necessary to have data for two accounting years for preparing fund flow statement.	For preparation of P & L account data for one accounting year is only required.

Summary:

Fund flow statement is prepared to know the flow of fund. In this statement 'fund' refers to working capital. Working capital is calculated by deducting current liabilities from current assets. If one item of current and other item of non-current asset increased or decreased, then, there will be a flow of fund. Fund flow statement is useful for internal as well as external users in various ways. On several bases, income statement is different from Fund flow statement.

Self Check Questions:

1. Explain the meaning of Funds Flow Statement. Explain its objects.
2. "A Fund Flow Statement is a good substitute for an income statement." Explain this statement and distinguish the two statements.
3. What is Fund Flow Statement? Examine its uses and significance for management.

Lesson 8

SOURCES & USES OF FUNDS

Objectives:

- To explain the working knowledge of statement of working capital change.
- To discuss the limitations of fund flow and cash flow statement.

Structure:

- Sources of funds
- Applications/uses of funds
- Technique of preparing fund flow statement
- Changes in working capital
- limitations of fund flow and cash flow statement.
- Illustrations
- Summary
- Self Check Questions

SOURCES OF FUNDS:

Meaning of Sources of funds: All the items related to business transactions of organization which increase working capital are known as sources of funds. Following can be the main sources of funds:

(1) Profit from operation: Net profit earned as a result of business operations of an organization are treated as first source of funds. Profit from operation is ascertained after deduction of cost of goods sold and other operating expenses from revenues or total sales.

Important point: detailed description of calculation of profit from operations is given in coming pages.

(2) Increase in non-current liabilities or long-term liabilities: The second important source of fund is receipt of cash from long term loans or long term liabilities. Long term loan, public deposits and issues of debentures for cash are included in long term liabilities. These increase long term liabilities and current assets. They do not affect current liabilities as a result working capital increasing. Issue of debentures for consideration other than cash is not treated as source of funds. Net amount received from debentures (after deducting discount and adding premium to face value) is treated as source of fund,

(3) Sale of Fixed Assets: As a result of sale of fixed assets, such as land, building, plant, machinery, long term investments etc. amount of fixed assets decreases and as a result of increase in cash and debtors amount of current assets increases, this increases working capital which is treated as source of fund.

(4) Increase in Share Capital: Increase in share capital is also a source of creation of funds. Net amount received from issue of shares for cash (Face value + Premium - Discount = Net amount received) increase current assets but current liabilities remain unchanged. With this source working capital also increases. **(Issue of Shares for Consideration other than cash or for redemption of debenture and preference shares or for Purchase of fixed assets is not treated as source of fund)**

(5) Non-trading Receipts: Amount received from non-trading receipts such as interest received on investments, dividends received, gifts, donation, rent received, compensation received etc also increase working capital thus, these are also treated as source of fund.

APPLICATION OR USES OF FUNDS

Meaning of Application of Funds: Transactions which result in decrease in working capital are known as application of funds. Following are the main items of application of funds:

(1) Operation losses: Quantity of funds decrease due to losses sustained in operation of business as a result amount of assets decrease or liabilities increase. Fund of business goes out of business due to losses sustained during operation of business.

(2) Purchase of Non-current Assets or Fixed Assets: Amount spent in purchase of fixed assets, such as land, building, plant, machinery, furniture, long term investment is treated as use of fund. Although with the purchase of fixed assets it increases but when they are purchased for cash, they will decrease current assets or when purchased on credit they will increase current liabilities.

(3) Payment of Non-current Liabilities or Fixed or Long-term Liabilities: When long term loans (including interest) and debentures (including premium) are paid in cash, money goes out of business which is treated as use of fund. Although this transaction does not affect current liabilities.

(4) Reduction in Capital fund: Redemption of preference shares on premium, repurchase of equity shares on premium, payment of dividend out of retained earnings (if this item is treated as long term liability) is treated as use of fund, as in above condition Current assets (cash) decreases without affecting current liabilities as a result net working capital decreases.

(5) Payment of dividend, tax and other non-trading liabilities: Payment of dividend, tax, loss due to fraud, donation, gift, compensation payable on defeat in litigation in cash is treated as use of fund, as a result of these payments current assets (cash-in-hand or cash at bank) decrease whereas current liabilities remain unaffected and due to this working capital decreases.

Important Point: If provision for taxes has been treated as current liabilities than payment of tax shall not be treated as use of funds.

TECHNIQUE OR PROCEDURE OF PREPARING A FUND FLOW STATEMENT

Fund flow statement is generally prepared for one year, with the help of comparative balance sheets for two years, P & L account and other known informations.

In practice, fund flow statement is prepared in two parts:

- (1) Schedule of changes in working capital.
- (2) Statement of sources and uses of funds.

Important Point: With an objective to make study easier, technique of preparing fund Flow statement is classified by dividing it into three parts:

- (1) Preparation of schedule of changes in working capitals.
- (2) Calculation of funds/profits from operation and ascertain the amount related to fixed assets and long term liabilities.
- (3) Preparation of Statement of sources and uses of funds.

SCHEDULE OF CHANGES IN WORKING CAPITAL

The schedule prepared to depict changes, in current assets and current liabilities which, arise due to flow of fund is known as schedule of changes in working capital. This schedule depicts the changes taking place in individual items of current assets and current liabilities between balance sheets of two accounting periods. This schedule is prepared with the help of details of current assets and current liabilities.

Current assets – Current liabilities = Working Capital.

RULES REGARDING PREPARATION OF SCHEDULE OF CHANGES IN WORKING CAPITAL

Following are the rules regarding preparation of schedule of changes in working capital:

(1) Increase in Current Assets Increases Working Capital: Increase in current assets of current year in comparison to previous year is shown in increase column. According to rules of accounting increase in current assets is debited thus, on the basis of this rule increase in current assets is shown in increase column (which is also known as debit column).

(2) Decrease in Current Assets decreases working capital: Decrease in current assets of current year in comparison to previous year is shown in decrease column. According to the rules of Accounting decrease in current assets is credited thus on the basis of this rule decrease in current assets is shown in decrease column (which is also known as credit column).

(3) Increase in current liabilities decreases working capital: Increase in current liabilities of current year in comparison to previous year is shown in decrease column. **According to the rules of accounting** increase in current liabilities are credited thus, on the basis of this rule increase in current liabilities is shown in decrease column which is also known as credit column.

(4) Decrease in current liabilities increases working capital: Increase in current liabilities of current year in comparison to previous year is shown in increase column. **According to the rules of Accounting** decrease in working capital is debited, thus on the basis of this rule decrease in current liabilities is shown in increase column, (which is also known as increase column).

PROFORMA OF SCHEDULE OF CHANGES IN WORKING CAPITAL

Following is the proforma of schedule changes in working capital

Schedule of Changes in Working Capital

(Name of the Company)

Particulars	Previous Year	Current Year	Changes in (Effects on) Working Capital	
			Increase (Debit)	Decrease (Credit)
Current Assets:				
Cash in hand	-			
Cash at bank	-			
Bills Receivable/Notes Receivable	-			
Debtors (Gross) or Book Debts or Account Receivable	-			
Stock (Inventories)	-			
Prepaid Expenses/unexpired exp.	-			
Accrued Incomes/Income Receivable	-			
Temporary Investment or	-			
Marketable Securities or Short-term Investments	-			
Total	-			
Current Liabilities:				
Creditors/Accounts Payable	-			
Bills Payable/Notes Payable	-			
Bank Overdraft	-			
Temporary Advances	-			
Income Received in Advance	-			
Owing/Outstanding Expenses	-			
Provision for Bad and Doubtful Debts	-			
Total	-			
Working Capital = CA - CL	-			
Increase/Decrease in Working Capital	-		Balancing figure Decrease in W.C.	Balancing figure Increase in W.C.
	-			
	-			

Total of Increase Column - Total of decrease column = Increase in working capital.
 Total of decrease Column - Total of increase column = Decrease in working capital.

Important Points:

- (1) If provision for taxation and proposed dividend are included in current liabilities then only these shall be shown in schedule of changes in working capital.
- (2) While preparing schedule of changes in working capital, additional information given outside balance sheet is not included in schedule.

Illustration 1:

From the following balance sheets, prepare a schedule of changes in working capital:

Particulars	31 st March	
	2011	2012
Assets:		
Cash in hand	5,000	7,000
Cash at Bank	7,000	9,000
Book Debts	12,000	11,000
Inventory	4,000	3,000
Bills Receivable	2,000	1,500
Prepaid Expenses	200	300
Short term Investment	5,000	8,000
Accrued Interest	1,000	600
Building	20,000	22,000
Plant and Machinery	9,000	6,000
	65,200	68,400
Liabilities :		
Accounts Payable	8,000	6,000
Notes Payable	3,000	2,000
Bank Overdraft	4,000	3,000
Outstanding Expenses	300	200
Provision for Bad Debts	500	700
Share Capital	20,000	20,000
Debentures	20,000	30,000
Mortgage Loan	9,400	6,500
	65,200	68,400

Solution:**Schedule of Changes in Working Capital**

Particulars	31 st March 2011	31 st March 2012	Charges in Working Capital	
			Increase (Debit)	Decrease (Credit)
Current Assets:				
Cash in hand	5,000	7,000	2,000	-
Book Debts	12,000	11,000	-	1,000
Cash at Bank	7,000	9,000	2,000	-
Inventory	4,000	3,000	-	1,000
B/R	2,000	1,500	-	500
Prepaid Expenses	200	300	100	-
Short term Investments	5,000	8,000	3,000	-
Accrued Interest	1,000	600	-	400
Total Current Assets	36,200	40,400		
Current Liabilities:				
Account Payable	8,000	6,000	2,000	-
Notes Payable	3,000	2,000	1,000	-
Bank Overdraft	4,000	3,000	1,000	-
Outstanding Expenses	300	200	100	-
Provision for Bad Debts	500	700	-	200
Total of Current Liabilities	15,800	11,900		
Working Capital				
(Current Assets - Current Liabilities)	20,400	28,500	-	8,100
Net Increase in Working Capital	8,100	-	-	-
	28,500	28,500	11,200	11,200

CALCULATION OF FUNDS FROM OPERATIONS (PROFIT) OR FUNDS USED IN OPERATIONS (LOSS)

For any business organization profits from operation are treated as source of fund and loss from operation is treated as use of fund.

While preparing fund flow statement, net profit (profit disclosed by P & L account) cannot be included in the category of profit from operations, as while calculating net profit few expenses are shown on debit side of P & L account which, do not affect working capital und which are not paid in cash. Thus, funds from operation is calculated

by adding or deducting non-cash items to net profit or loss disclosed by P & L account.

ITEMS TO BE ADDED BACK TO NET PROFIT

Following are the items which shall be added back to net profit:

(1) Non-fund items: Items which do not affect working capital (which means they do not decrease current assets or increase current liabilities) are known as Non-fund items.

Following are the main examples of non-fund items:

Depreciation: Depreciation is kept in the category of non-fund items as depreciation is never paid in cash thus, it is added back to net profits.

Is Depreciation a source of funds?

(1) Depreciation is not a source of funds: Following arguments can be given in favour of this

(i) Amount of depreciation is shown on debit side of P & L account and is deducted out of related asset in balance sheet, as both P & L account and fixed assets account are non-current accounts, therefore, depreciation is a not fund item. On the basis of above argument it neither a source of fund nor it is a use of fund.

(ii) While calculating funds from operations of business, adding back of depreciation to profits (which has previously deducted out of profits) does not mean sources of fund, as it is non-cash items and this does not affect the funds of organization.

(2) Depreciation is a Source of funds: Following arguments can be given in favour of this:

(i) Taxable income is reduced after deducting depreciation from amount of net profit consequently tax liability is reduced. Thus, in this manner savings in amount payable as tax due to depreciation can be treated as source of fund.

(ii) On utilizing the asset owned by firm, instead of rented asset, the amount which is payable as rent can be saved, as rent payable is treated as outflow of funds therefore, savings in rent can be treated as source of fund.

(B) Writing off the Fictitious and Intangible Assets: These assets do not have real value. Following are the main examples of these assets

Examples of Fictitious Assets: Preliminary expenses, deferred revenue expenditure, discount on issue of shares and debentures. premium on redemption of preference shares and debentures.

Examples of Intangible Assets: Goodwill, patent rights, trademarks, copy right etc.

While writing off above mentioned assets, those are written on debit side of P & L account, these assets do not affect current assets or current liabilities of business, therefore, for calculation of funds from operation these are added back to net profits.

Important Point: When amount of such assets given in balance sheet of current year is lesser than the amount given in balance sheet of previous year then it is assumed that this difference has been written off by P & L account.

(2) Non trading losses or Non-trading charges: All such losses or charges which are non-trading are known as non trading losses or charges. Non-trading losses are added back to net profits. Following are the main examples of these.

(A) Loss on sale of fixed or non-current assets: Losses arising due to sale of land, building, plant, machinery, furniture, long term investment etc are recorded on debit side of profit & Loss account.

(B) Appropriation of Profits: General reserve, reserve fund, sinking fund, dividend equalization fund, debenture redemption fund and reserve for contingencies etc are again recorded on debit side of P & L account as they do not affect the working capital of business.

(C) Provision for Taxation: Provision for taxation is again added back to profits provided, this is not shown in schedule of changes in working capital as current liability.

(3) Dividend on Shares: Dividend, Interim dividend or proposed dividend payable on shares is also added back to profits. Provided, this is not included in schedule of changes in working capital as current liability.

Items to be deducted from net profit: Item which do not give birth to trading income/Profits and funds (which do not increase current assets or decrease current liabilities) are deducted from net profit, as working capital remains unaffected by these.

Following are the main examples of such items:

- (i) Interest and dividend received on investments.
- (ii) Profit on sale of fixed or non-current assets
- (iii) Appreciation in the value of fixed Assets
- (iv) Excess provision transferred back to P & L account.

LIMITATIONS OF FUND FLOW AND CASH FLOW STATEMENT:

(A) LIMITATION OF FUND FLOW STATEMENT:

Following are the limitations of fund flow statement:

- (1) Fund flow Statement is related to past analysis, it is not clear in this statement what will be the condition of funds in future or how much funds will be required?
- (2) Fund Flow Statement presents illusionary results, as with this statement complete information regarding total cash receipts and payment is not available.
- (3) Basis of information of change in financial condition of business is not revealed by this statement.
- (4) Fund Flow Statement does not present a separate analysis of changes in each item of working capital.
- (5) Fixed and long term liabilities are not included in fund flow statement whereas these also affect the financial condition of business equally.

(B) LIMITATION OF CASH FLOW STATEMENT:

Following are the main limitations of cash flow statement:

- 1. Incomplete substitute:** Cash flow statement is not a substitute of income statement as net cash flow depicted by cash flow statement is not equal to net profit shown by income statement.
- 2. It does not show the liquidity position of the firm:** This statement depicts the inflow and outflow of cash. Liquidity position of the firm cannot be ascertained from this.
- 3. Accrual basis:** Cash flow statement does not pay attention to accrual basis concept

of accounting.

4. Misleading comparisons: Cash flow statement has proved to be misleading in comparison of industry and firm.

Illustration 1.

From the data given below, prepare a Funds Flow Statement and the schedule of changes in working:

Balance Sheets
(as at 31st March)

Liabilities	2011	2012	Assets	2011	2012
	Rs.	Rs.		Rs.	Rs.
Share Capital	1,00,000	1,25,000	Land and Building	1,00,000	95,000
General Reserve	25,000	30,000	Plant	75,000	84,500
P&La/c	15,250	15,300	Stock	50,000	37,000
Creditors	75,000	67,600	Debtors	40,000	32,100
Provision for Taxation (current liability)	15,000	17,500	Cash in hand	250	300
Bank Loan	35,000	—	Cash at Bank	—	4,000
	2,65,250	2,55,400	Goodwill	—	2,500
				2,65,250	2,55,400

Additional Informations:

- (a) Dividend of Rs. 11,000 was paid during the year 2012
(b) Depreciation charged on Plant Rs. 7,000.

Solution:

Schedule of changes in Working Capital

Particulars	31 st March		Changes in Working Capital	
	2011	2012	Increase (Debit)	Decrease (Credit)
Current Assets :				
Stock	50,000	37,000	-	13000
Debtors	40,000	32,100	-	7900
Cash in hand	250	300	50	-
Cash at Bank	-	4,000	4000	-
	90,250	73,400		
Current Liabilities:				
Bank Loan	35,000		35000	-
Creditors	75,000	67,600	7400	-
Provision for taxation	15,000	17,500	-	2500
	1,25,000	85,100		
Working Capital (Current Assets - Capital Liabilities)	-34,750	-11,700		
` (34750 - 11,700)	+23,050			
Increase in Working Capital	-	-	-	23050
	-11700	-11700	46450	46450

Fund Flow Statement
(for the year ending 31st March, 2012)

Sources of Funds:	Rs.
(i) Issue of share capital (Rs. 1.25,000 - 1.00,000)	25000
(ii) Funds from operation (profit)	28050
Uses of Funds:	53050
(i) Purchase of Plant	16500
(ii) Purchase of Goodwill	2500
(iii) Payment of Dividend	11000
(iv) Increase in Working Capital	23050
	53050

(1) Calculation of funds from operation:

Adjusted Profit & Loss Account			
	Rs.		Rs.
To General Reserve (Rs. 30,000 - 25,000)	5000	By Balance b/d	15250
To Dividend Paid	11000	By Funds from operation	28050
To Depreciation : Plant Rs. 7,000		(Bal. fig.)	
Building (1,00,000 - 95,000) 5,000	12,000		
To Balance c/d	15,300		
	43,300		43,300

(2) Calculation of New Plant purchased:

Dr.		Plant Account		Cr.	
2011		Rs.	2012		Rs.
April 1	To Balance b/d	75,000	Mar. 31	By Depreciation	7,000
	To Cash a/c (New purchase) (Bal. fig. out flow)	16,500	Mar. 31	By Balance c/d	84,500
		91,500			91,500

Illustration 2.

From the following balance sheets, make out: (1) Statement of changes in working capital. (2) Funds Flow Statement.

Balance Sheet

Liabilities	2011	2012	Assets	2011	2012
	Rs.	Rs.		Rs.	Rs.
Equity Share cap.	3,00,000	4,00,000	Goodwill	1,00,000	80,000
8% Pref. Share cap.	1,50,000	1,00,000	Land & Building	2,00,000	1,70,000
Cap. Reserve	10,000	20,000	Plant	80,000	2,00,000
General Reserve	30,000	50,000	Investment	20,000	30,000
P&La/c	30,000	48,000	Debtors	1,40,000	1,70,000
Proposed Dividend			Stock	77,000	1,09,000
(NCL)	42,000	50,000	Bills Receivable	20,000	30,000
Creditors	25,000	47,000	Cash in hand	15,000	10,000
Bills Payable	20,000	16,000	Cash at Bank	10,000	8,000
Liability for Exp.	30,000	36,000	Preliminary Exp.	15,000	10,000
Prov. for taxation					
(NCL)	40,000	50,000			
	6,77,000	8,17,000		6,77,000	8,17,000

Addition Informations:

A piece of land had been sold out in 2012 and the profit on sale has been credited to capital Reserve.

A machine has been sold for Rs.10,000. The written down value of the machine was Rs. 12,000; Depreciation of Rs. 10,000 is charged on plant account in 2012.

The investments are trade investments. Rs. 3,000 by way of dividend is received including Rs. 1,000 from pre-acquisition profit which has been credited to investment account. During the year investments costing Rs. 5,000 were sold for Rs. 4,800.

An interim dividend of Rs. 20,000 has been paid in 2012.

Note: NCL means non-current liability.

Solution:**Schedule of Changes in Working Capital**

Particulars	31st March		Changes in Working Capital	
	2011	2012	Increase (Debit)	Decrease (Credit)
	Rs.	Rs.	Rs.	Rs.
Current Assets :				
Debtors	1,40,000	1,70,000	30,000	—
Stock	77,000	1,09,000	32,000	—
Bills Receivable	20000	30000	10000	
Cash in hand	15000	10000		5000
Cash at Bank	10000	8000		2000
Total	262000	327000		
Current Liabilities:				
Creditors	25000	47000		22000
Bills Payable	20000	16000	4000	
Liability for Expenses	30000	36000		6000
Total	75000	99000		
Working Capital (CA - CL)	187000	2,28,000		
Increase in Working Capital	41,000			41000
	228000	228000	76000	76000

Fund Flow Statement

Sources of fund	Amount	Application of fund	Amount
Funds from operation	193200	Red. of Pref. share Capital	50000
Issue of share capital (400000 - 300000)	100000	Purchase of Plant	142000
Sale of Land	40000	Purchase of Investment	16000
Sale of Machine	10000	Proposed Dividend paid	42000
Dividend received	3000	Interim Dividend	20000
Investment sold	4800	Tax-Paid	40000
		Increase in WC	41000
	351000		351000

Land and Building Account

		Rs.			Rs.
	To Balance b/d	2,00,000		By Cash a/c (Bal. fig.)	(40000)
	To Cap. Reserve	10,000		By Balance c/d	1,70,000
		2,10,000			2,10,000

Dr.		Plant and Machinery Account		Cr.	
To Balance b/d	80000	By Cash a/c (sale of plant)	10000		
To Cash a/c New chase (Bal. fig.)	142000	By Adj P & L a/c (Loss)	2000		
		By Dep. a/c	10000		
		By Balance c/d	200000		
	222000		222000		

Investment Account

To Balance b/d	20000	By Cash a/c (sale of Investment)	4800
To Cash a/c New purchase (Bal. fig.)	16000	By Adj P & L a/c (Loss)	200
		By Dividend a/c	1000
		By Balance c/d	30000
	36000		36000

Adjusted P & L Account

	Rs.		Rs.
To General Reserve (50,000-30,000)	20,000	By Balance b/d	30,000
To Proposed Dividend	50,000	By Dividend received (3,000- 1,000)	2,000
To Goodwill (Rs. 1,00,000- 80,000)	20,000	By Funds from operation (Bal. fig.)	1,93,200
To Loss on sale of Investment	200		
To Loss on sale of plant	2,000		
To Depreciation	10,000		
To Preliminary Exp. (W. off) (Rs. 15,000- 10,000)	5,000		
To Interim Dividend	20,000		
To Prov. for Taxation	50,000		
To Balance c/d	48,000		
	2,25,200		2,25,200

Illustration 3.

From the following information extracted from the books of Rita! Ltd., prepare statements of changes in financial position in proper form:

Balance Sheet

	31-3-11	31-3-12
	Rs.	Rs.
Assets:		
Fixed Assets (Net)	51,000	62,000
Long term Investments	3,000	8,000
Current Assets	24,000	37,500
Discount on issue of shares and Debentures	1,000	500
	79,000	1,08,000
Liabilities and Capital:		
Equity share capital	30,000	35,000
6% Pref. share capital	10,000	20,000
6% Debentures	20,000	10,000
Reserves and Surplus	11,000	27,000
Provision for Doubtful Debts	1,000	1,500
Current Liabilities	7,000	14,500
	79,000	1,08,000

Additional Informations:

1. A machine costing Rs. 7,000, book value Rs. 4,000 was sold for Rs. 2,500.
2. A dividend of 15% was paid on equity shares during the current year.
3. Provision for Depreciation Rs. 15,000 (2011) and Rs. 19,000 (2012).
4. Debentures were redeemed at a premium of 5%.
5. Stock which was valued at Rs. 9,000 on 2011 was written up to cost Rs. 10,000 for preparing the P & L a/c of 2012. Debtors are likely to realised in full.

Solution : Schedule of Changes in Working Capital

Particulars	31st March		Charges in Working Capital	
	2011	2012	Increase (Debit)	Decrease (Credit)
	Rs.	Rs.	Rs.	Rs.
Current Assets : (Rs. 24,000 + 1,000*)	25,000	37,500	12,500	—
Total	25,000	37,500		
Current Liabilities	7,000	14,500		7,500
Working Capital (CA—CL)	18,000	23,000		
Increase in working capital	5,000	—		5,000
	23,000	23,000	12,500	12,500

* Writing up of opening stock in 2012 by Rs. 1,000.

Funds Flow Statement

Sources of Funds	Amount	Application of Funds	Amount
	Rs.		Rs.
Issue of Equity Share Cap.	5,000	Purchase of Investments	5000
Issue of 5% Pref. Share Cap.	10,000	Red. of Debentures with premium	10500
Sale of Machine	2,500	Purchase of fixed assets	22000
Fund from operations	29,500	Payment of Dividend	4500
		Increase in Working Capital	5000
	47,000		47,000

Dr. Fixed Assets Account Cr.

	Rs.		Rs.
To Balance <i>b/d</i> (Rs. 51,000+15,000)	66,000	By Cash/Bank a/c (sale of machine)	2,500
To Cash a/c (New purchase) (Bal. fig.)	22,000	By Prov. for Dep. a/c	3,000
		By Res. & Surplus a/c (Loss on sale) (Rs. 4,000 - 2,500)	1,500
		By Balance c/d (Rs. 62,000 + 19,000)	81,000
	88,000		88,000

Dr.		Provision for Depreciation Account		Cr.	
		Rs.			Rs.
	To Fixed Assets a/c	3,000		By Balance h/d	15,000
	To Balance c/d	19,000		By Res. & Surplus a/c	7,000
		22,000			22,000

Dr.		Provision for Doubtful Debts Account		Cr.	
		Rs.			Rs.
	To Balance c/d	1,500		By Balance b/d	1,000
				By Res. & Surplus a/c	500
		1,500			1,500

Prov. for D/D a/c can be shown in die schedule of working capital.

Adjusted Reserves and Surplus Account (P & L Account)

To Loss on sale of fixed Assets	1,500	By Balance b/d	11,000
To Prov. for Dep. a/c	7,000	By Opening stock (written up in 2004)	1,000
To Dividend paid (15% on Rs. 30,000)	4,500	By Funds from operation	29500
To Discount on Issue of Shares & Deb. (Rs. 1,000 - 500)	500		
To Prem. on Red. on Deb.	500		
To Prov. for Doubtful Debts	500		
To Balance c/d	27,000		
	41,500		41,500

Summary:

In fund flow analysis mainly two statements are prepared viz., schedule of changes in working capital and sources and uses of funds. Former statement is prepared by using current assets and current liabilities and later statement is prepared to know the various sources and applications of funds. There are different sources and uses of funds. Fund flow analysis is based on accounting rules, therefore debit and credit system is followed though, the terms increase or decrease sources or applications are used. There are

certain limitations of fund flow and cash flow statements because they eliminate the certain non-fund/non-cash items.

Self Check Questions

1. Define the term fund and give the usual sources and applications of fund.
2. Define the term 'Fund' and 'Flow' in respect of Fund Flow Statement. How is it prepared?
3. "The analysis of flow of funds through an organization can be very useful to the management." Elucidate this statement and explain the limitations of fund flow statement.
4. What is a schedule of changes in working capital? How it prepared?
5. What are the causes for changes in working capital of a concern? Give specimen of fund flow statement and schedule of changes in working capital? How can these changes be shown in a statement ?

Practical Questions:

1. Balance Sheet of Surya Ltd. as on 31 st March, 2011 & 2012 are as under:

Balance Sheet

Liabilities	2011	2012	Assets	2011	2012
	Rs.	Rs.		Rs.	Rs.
Equity Share Capital	90,000	1,30,000	Fixed Assets	93,400	1,66,000
General Reserve	10,000	15,000	Stock	22,000	26,000
P & L a/c	20,000	30,000	Debtors	36,000	39,000
10% Deb.	—	20,000	Cash & Bank	4,000	5,000
Current Liabilities :	37,400	42,000	Preliminary Exp.	2,000	1,000
	1,57,400	2,37,000		1,57,400	2,37,000

Additional Information:

(i) Provision for depreciation on fixed assets Rs. 23,000, (ii) Dividend of Rs. 20,000 was paid on equity share capital.

Prepare a schedule of changes in working capital and a Funds Flow Statement.

[Ans.: Increase in working capital Rs. 3,400 (C.A. Rs. 28,000 - 24,600 or Dr. Rs. 8,000 - 4,600 Cr.); Total of F.F. S. Rs. 1,19,000; Funds from Operation Rs. 59,000; Purchase of F. Assets Rs. 95,600 (Rs. 1,66,000 + 23,000 - 93,400); Issue of S. Cap. Rs. 40,000]

Hint: Fund From Operation: Rs. 30,000 + 5,000 (G.R.) + 20,000 (D) + 23,000 (Dep.) + 1,000 (P.E.) - 20,000)

2. Construct a Fund Flow Statement of a Company from the following information:

Liabilities	2011	2012	Assets	2011	2012
	Rs.	Rs.		Rs.	Rs.
Share Capital	35,000	43,500	Plant	15,000	17,000
Retained Earnings	15,000	19,500	Building	20,000	16,000
6% Debentures	22,000	22,000	Land	4,000	4,000
Current Liabilities	30,000	32,000	Patent	1,000	900
Accumulated Dep.	5,000	2,800	Cash	40,000	44,400
			Debtors	10,000	20,700
			Stock	15,000	15,000
			Discount on Deb.	2,000	1,800
	1,07,000	1,19,800		1,07,000	1,19,800

Additional Information:

(i) Income for the period was Rs. 10,000, (ii) A building that costs Rs. 4,000 and which had a book value of Rs. 1,000 was sold for Rs. 1,400; (iii) Depreciation charges for the period were Rs. 800; (iv) Share issued amounted Rs. 5,000; (v) Cash dividend of Rs. 2,000 and share dividend of Rs. 3,500 were declared and paid.

Ans.: Increase in W.C. Rs. 13,100 (15,100 (Dr.) - 2,000 (Cr.)); Profit from Operation Rs. 10,700; Purchase of Plant Rs. 2,000; Total of F. F. Statement Rs. 17,100.

Hint : While ascertaining operating profits on the basis of retained earnings share dividend of Rs. 3,500 shall be shown on debit side of Adj. P & L a/c. Ascertain funds from business operation on the basis of current years profit Rs. 10,000. Cash dividend shall not be shown in Adj. P & L a/c.

Lesson 9

CASH FLOW STATEMENT

Objective:

- The basic objective of this lesson is to acquaint the students with working knowledge of cash flow statement (CFS) and Accounting Standard - 3.

Structure:

- Meaning of Cash Flow Statement
- Objectives/Uses or importance of Cash Flow Statement
- Difference between Cash Flow Statement and Fund Flow Statement
- Difference between Cash Flow Statement and Income Statement
- Difference between Cash Flow Statement and Cash Budget
- Cash Flow Statement according to AS – 3 (Direct Method) and Indirect Method.
- Illustrations
- Summary
- Self Check Questions

Meaning of Cash Flow Statement:

Cash flow statement is the statement which depicts the inflow (sources) and outflow (uses) of cash and cash equivalents during the specified period in an organization. This statement shows the reasons for changes in cash balances during two balance sheet periods and presents the analytical study. This also depicts the receipt and outflow of cash on the basis of information provided by profit & loss account and also tallies the opening and closing balance of cash.

Definition:

Cash flow statement is a statement setting out the flow of cash under different heads of sources and their utilization to determine the requirements of cash during the given period and to prepare for its adequate provisions."

- I.C.W.A. (India)

The statement which analyses the changes in liquidity position of any organization on cash basis is known as cash flow statement.

Names of Cash flow Statement: Statement of changes in financial position-cash basis, fund flow statement-cash basis.

OBJECTIVES AND USES OR IMPORTANCE OF CASH FLOW STATEMENT

According to Accounting Standard- the main objective of preparation of cash flow statement, is to provide information to users regarding cash flow which gives description of changes in cash or cash equivalents. In brief, following are the objectives and uses of cash flow statement:

1. Helpful in short term policies of financial planning:

Cash flow statement provides several informations to finance managers for formulating policies for short term financial requirements on the basis of which, finance manager is able to ascertain the amount of cash which will be required in future and how much cash will be available from internal sources and how much will have to be arranged from external sources.

2. Useful in preparing cash budget:

Cash flow statement helps managers in preparing cash budget, it gives information about preparing cash budget, it gives information about surplus or deficiency of cash to managers and on the basis of this managers can plan to invest surplus of cash in short term investments or to cover the deficit they can search for sources of short term loans.

3. Knowledge of solvency:

Knowledge of solvency can be obtained with the help of cash flow statement.

4. Helpful in control:

Cash flow statement acts as a control device for finance managers. With comparison of cash flows statement with cash budget, management can come to know about the extent, to which financial sources have been used, in accordance with plan.

5. Helpful in internal financial management:

On the basis of information available from cash flow statement payment of long-term liabilities, long-term investment and formulation of dividend policy is facilitated.

6. Useful to external investors:

External investors are able to obtain information at liquidity of organization with the help of cash flow statement on the basis of which they can take decision regarding lending money to organization or not.

7. Study of the trends of cash receipts and payments from various activities: With the help of this statement, managers are able to obtain information about the frequency of cash receipts from current assets and what is frequency of payments of current liabilities so that future cash requirements can be ascertained.

DIFFERENCE BETWEEN CASH FLOW STATEMENT AND FUND FLOW STATEMENT

S.No.	Basis of Difference	Cash Flow Statement	Fund Flow Statement
1	Meaning of Fund	Cash in Cash flow statement refers to cash and short-term and liquid assets	Fund in fund flow statement refers to working capital (current assets – current liabilities) here cash is a part of working capital.
2.	Basis of Analysis	Changes taken place in quantity of cash within two accounting periods are analyzed in cash flow statement	Changes taken place in working capital within two accounting periods are analyzed in fund flow statement.
3.	Principle of Accounting	Cash flow statement is prepared on cash basis.	Fund flow statement is prepared on accrual basis.
4.	Objects	The objective of this statement is to briefly present the changes taken place in cash position of the organization.	The objective of this statement is to briefly present the causes of changes in working capital.
5.	Usefulness	It is very useful while making short-term financial plan.	It is useful while making medium-term and long-term plan.
6.	Scope	Scope of this is narrow.	Scope of this is wide.
7.	Calculation	Cash from operation is calculated in this.	Funds from operations are calculated in this.
8.	Publication	According to Accounting Standard – 3 (amended), publication of cash flow statement is compulsory.	Publication of fund flow statement is not compulsory.

DIFFERENCE BETWEEN CASH FLOW STATEMENT AND INCOME STATEMENT

S.No.	Basis of Difference	Cash Flow Statement	Income Statement
1	Test of profitability	Profitability of sources of cash cannot be tested with cash flow statement.	Profitability of transactions of organization can be tested with the help of income statement.
2.	Accounting Concept	Cash flow statement is prepared on the basis of cash concept of accounting	Income statement is prepared on the accrual concept of accounting.
3.	Purpose	The primary purpose of preparing this is to ascertain the liquidity of the organization.	The primary purpose of preparing this is to estimate the profit generation capacity.

DIFFERENCE BETWEEN CASH FLOW STATEMENT & CASH BUDGET

According to **Gray and Jack Johnson** following are the major differences between cash flows statement and cash budget:

S.No.	Basis of Difference	Cash Flow Statement	Cash Budget
1	Subject Matter	Changes related to cash in part are studied in cash flow statement	Changes related to flow of cash in future are estimated in cash budget.
2.	Period	Generally the period of cash flow statement is one year.	Generally the period of cash budget is weekly, monthly or quarterly.
3.	Technique of Analysis	Cash flow statement is a technique of past financial analysis.	Cash budget is a technique of future financial forecasting.
4.	Usefulness	Cash flow statement is useful for managers and external investors	Cash budget is useful for internal management.

Indian Accounting Standard-3: Institute of Chartered Accountants of India presented this Standard by the name of changes in financial position, in the year 1981. After this, in March, 1997 this standard was amended and presented by the name of cash flow statement. This standard is of compulsory nature. Now all those companies which are listed on stock exchange or those which have applied for listing and their sale is more than 50 crores in one accounting period have to compulsorily prepare cash flow statement according to Standard – 3.

CLASSIFICATION OF CASH FLOW ACCORDING TO AS-3

Meaning of cash Flow: In any organization inflows and outflows of cash and cash equivalents are termed as cash flow.

Meaning of cash: Cash refers to cash in hand and demand deposits with bank.

Meaning of cash equivalents: Cash equivalents are short-term, highly liquid investments that are readily convertible into known amounts of cash. For example treasury bills, commercial papers etc. (investments for 3 months or less fall under this category).

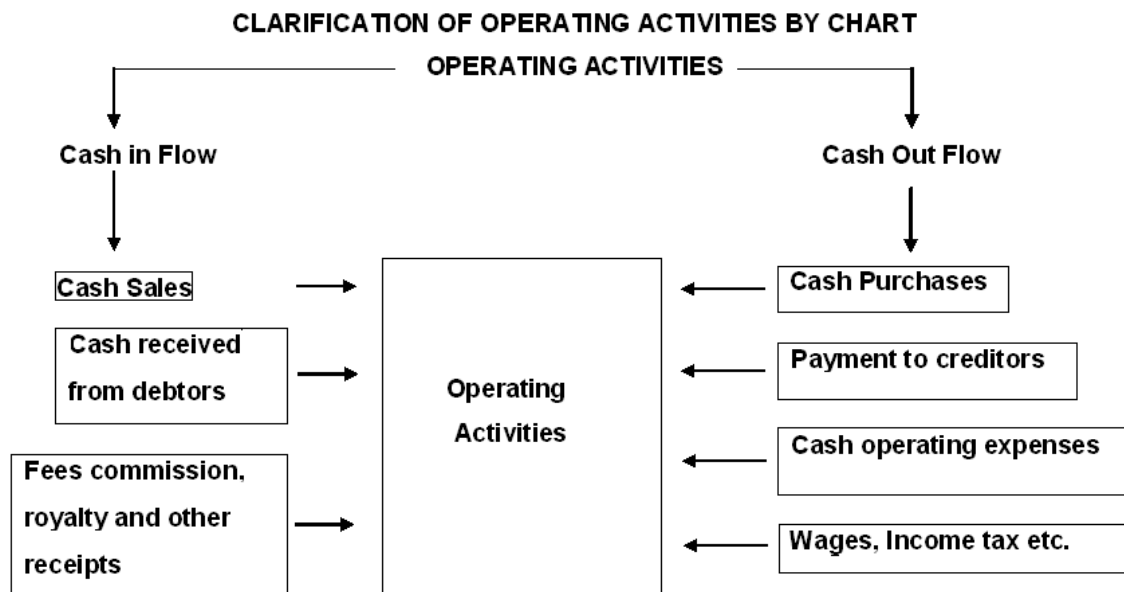
Cash flow or sources and application of cash: According to accounting Standard - 3 cash flow has been divided into three parts

- 1. Cash flow from operating activities:** Operating activities refer to those activities which generate revenue or are those activities which generate sufficient cash flow. Cash flow from operating activities is a result of those transactions which determine net profit/loss.

CASH FLOW FROM OPERATING ACTIVITIES

S.No.	Cash Inflow	Cash Outflow
1.	Cash sale of goods and services.	Cash payment to suppliers of goods and services.
2.	Cash received from Debtors.	Cash payments to creditors or their representatives.
3.	Cash receipts from royalties, fees, commissions and other revenue receipts. Cash receipts from claims, annuity and	In case of insurance company cash payments for insurance claims, annuity and other policy profits.

4.	other policy profits in case of insurance company.	Cash payment of Income Tax.
5.	Refund of Income tax unless it is related to specific financing and investing activities.	Cash payments relating to future contracts. Forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.
6.	Refund of Income tax unless it is related to specific financing and investing activities.	
7.	Cash receipts relating to future contracts, forward contracts, and option contracts and swap contracts when the contracts are held for dealing or trading purposes.	



Cash flow from Investing Activities: investing activities are the acquisition and disposal of long term assets and other investments not included in cash equivalents.

For example: Land, building, plant, machinery etc. Following is the clarification of cash flow from investing activities.

CASH FLOW FROM INVESTING ACTIVITIES

S.No.	Cash Inflow	Cash Outflow
1.	Amount received from sale of fixed assets (Including intangible assets).	Purchase of fixed assets (Including intangible assets, capital expenditure on research and development and expenses incurred on self produced fixed assets).
2.	Amount received from sale of shares, bonds or debentures of other companies excluding those receipts which are treated as cash or cash equivalent for business purposes.	Purchase of shares, bonds or debentures of other companies (excluding those payments which are treated as cash or cash equivalents for business purposes).
3.	Amount received as repayment of loans or advances given to third parties previously.	Cash advances and loans given to third parties (excluding loans and advances given to financial institutions).
4.	Cash receipts from future contracts, forward contracts, option contracts and swap contracts (excluding payments received from contracts held for trading or dealing purposes or classified under financing activities).	Cash payments for future contract forward contracts, option contracts and swap contracts (excluding payments made for trading or dealing purposes or classified under financing activities).
5.	Dividend and Interest received in cash.	
6.	Insurance claim received from insurance company for assets destroyed in accident.	

Financing Activities: Financing activities refers to those activities which are related to cash flow which provide capital and loan to organization. Cash flow from financing activities change the size and structure of capital and loan.

EXAMPLES OF CASH FLOW ARISING FROM FINANCING ACTIVITIES

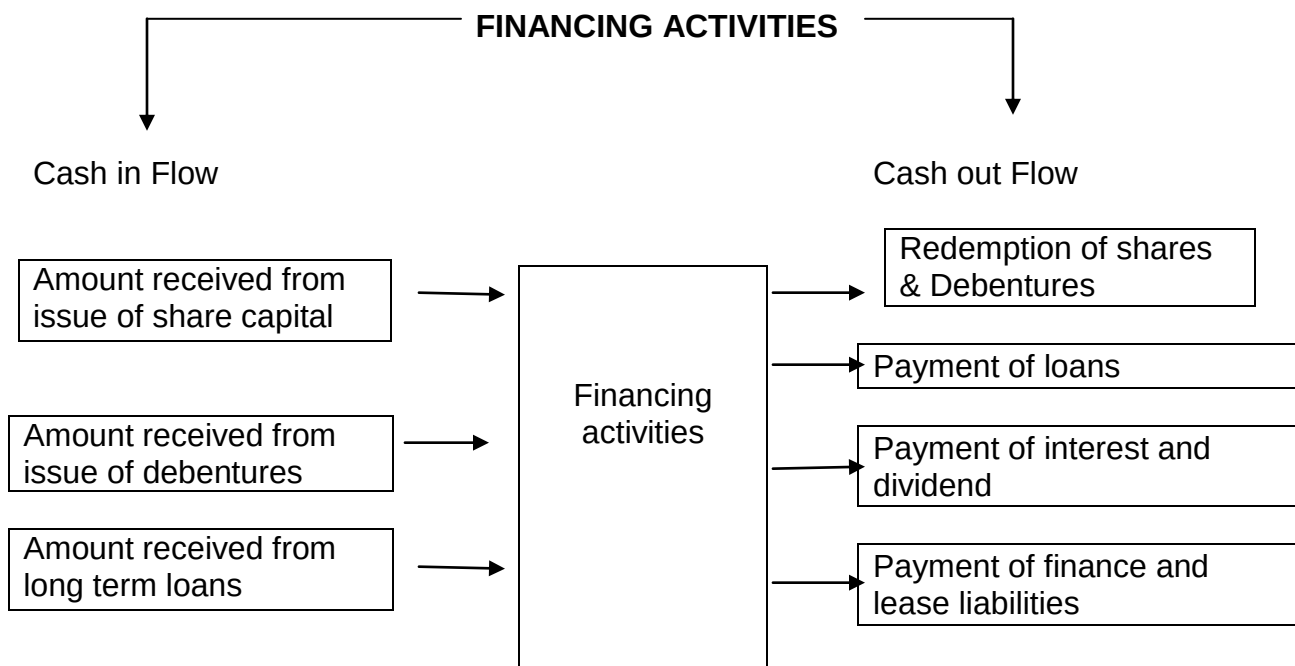
1. Cash receipts from issue of shares and securities of similar kind.
2. Cash receipts from debentures, loan, notes, bonds and other short-term and long-term loan.

3. Cash payments of amount taken on credit.
4. Payment of interest and dividend in cash.
5. Buy-back of equity shares, cash payments for redemption of preference shares, debentures bonds etc.

Important Point:

- (i) Issue of Bonus shares is not included in financial activities, as no cash is received by issue of these shares.
- (ii) While calculating net amount received from issue of shares and debentures, amount of premium is added to the net amount received and amount of discount is deducted.

CLARIFICATION OF FINANCING ACTIVITIES BY CHART



TREATMENT OF SOME SPECIAL ITEMS

Some specific clarifications have been given in paragraphs 25 to 28 of Accounting Standard-3 (Amended) in relation to transactions of cash flow from special items, which are as follows:

Foreign currency cash flows: Unreleased gains and losses arising from changes in foreign exchange rates are not cash flow. However, the effect of exchange rate changes

on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flow from operating, investing and financing activities.

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

For example : Amount received from insurance company for claim of loss of stock due to fire, flood etc. shall be shown in the cash flow related to operating activity. Similarly, amount received from bad debts, winning of lottery shall be shown separately by classifying them as operating, investing and financing activity.

Taxes on Income: Usually, taxes paid on income are classified as cash flow from operating activities. However, if cash flow is related to investing or financing activity then it shall be shown in related cash flow. In absence of clear identification or directions taxes on income shall be treated as cash flow from operating activities.

Interest and dividend: Cash flow arising from interest paid and interest and dividends received in the case of financial enterprise should be classified as cash flow from investing activities.

Non-cash transactions: Non cash transactions are not included in cash flow statement as there is no flow of cash from these. However, some important non-cash transactions are shown in form of note. Examples of non cash transaction:

- (i) The acquisition of business of other enterprise by means of issue of shares,
- (ii) Conversion of debt to equity,
- (iii) Issue of shares and debentures for purchase of fixed assets,
- (iv) Purchase of assets on credit.

Balance of Foreign Branches: Balances of foreign branches are not available due to exchange controls thus management should show the amount which has been kept for use of balances of cash and cash equivalents and is sufficient.

FORMATS OF CASH FLOW STATEMENT

Accounting Standard-3 (Amended) has not prescribed any format for cash flow statement. Following in the proforma of cash flow statement, prepared by direct and indirect method and which has been prescribed by SEBI and is used by maximum number of organizations.

Direct Method:

ACC Ltd.
Cash Flow Statement
(for the year ended.....)

	Rs.	Rs.
(A) Cash Flow from Operating Activities:		
Cash receipts from Customers/Debtors		
Cash paid to suppliers and Creditors		
Cash Generated from Operating Activities		
Income tax paid		
Cash flow before extra ordinary items		
(+) or (-) Extraordinary items		
Cash from (used in) operating activities		
(B) Cash Flow from Investing Activities:		
Purchase of Fixed Assets		
Proceeds from Sale of Fixed Assets		
Purchase of Investments (Long-Term)		
Proceeds from sale of Investments		
Interest received		
Dividend received		
Net Cash from (used in) Investing Activities		
(C) Cash Flow from Financing Activities:		

Proceeds from Issue of Share Capital		
Proceeds from Issue of Debentures		
Proceeds from Long-term Debts or Borrowings		
Repayment of Long-term Debts or Borrowings		
Redemption of Debentures and/or Pref. Share Capital		
Interest Paid		
Dividend Paid		
Net Cash From (used in) Financing Activities		
Net Increase (Decrease) in Cash and Cash Equivalents		
(A + B + C) + Cash and		
Cash Equivalents at the beginning of the year		
Cash and Cash Equivalents at the end of the year		

Indirect Method:

ACC Ltd. Cash Flow Statement
(For the year ended)

(A) Cash Flow from Operating Activities: Net Profit before tax and Extra ordinary Items: Add: Non-cash and Non-operating items : (Which have already been debited to P/L a/c) (i) Depreciation (ii) Goodwill Written off (iii) Preliminary Expenses written off (iv) Discount on Issue of Shares and Debentures (v) Underwriting commission (vi) Loss on sale of Fixed Assets and Long-term Investments vii) Foreign Exchange loss (viii) Transfer to Reserves (G. Reserve, Reserve fund contingency reserves and other reserves)) Loss on revaluation of fixed assets Non-Cash and Non-Operating items (which have already been credited to P & L a/c) (i) Profit on sale of fixed assets and long-term investments (ii) Interest and dividend received on investment (iii) Foreign Exchange gain (iv) Appropriation (Profit on revaluation of fixed assets)		
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(v) Reserve /Provision written back	-	-
	-	-
Operating Profit before Working Capital Changes		-
Add: Decrease in Current Assets (Debtors, B/R, Stock, Prepaid Exp.)	-	
Increase in Current Liabilities (Creditors, B/P. O/S Exp.)	-	
	-	-
Less : Increase in Current Assets	-	-
Increase in Current Liabilities	-	
Cash Generated from (used in) Operation before tax	-	-
Less : Tax paid		-
Cash Flow Before Extraordinary items		-
Add/Less : Extra ordinary Items (if any)		-
Net Cash from (Used in) Operating Activities		-
(B) Cash Flow from Investing Activities :		
Purchases of Fixed Assets	(...)	
Proceeds from Sale of Fixed Assets		
Purchase of Investments (Long-term) *	(...)	
Proceeds from Sale of Investments		
Interest received		
Dividend received		
Net Cash from (used in) Investing Activities		
(C) Cash Flow from Financing Activities :		
Proceeds from Issue of Share Capital		
Proceeds from Issue of Debentures		
Proceeds from Long-term Debts or Borrowings		
Repayment of Long-term Debts or Borrowings Redemption of Debentures and/or Pref. Share Capital	(...)(...)	
Interest Paid	(...)	
Dividend Paid	(...)	
Net Cash from (used in) Financing Activities		
Net Increase (Decrease) in Cash and Cash Equivalents (A + B + C)		
+ Cash and Cash Equivalents at the beginning of the year		
Cash and Cash Equivalents at the end of the year		

Important Points:

- (1) Total of operating, investing, financing activities and opening balance of cash is equal to the closing balance of cash.
- (2) Total of cash flow under operating, investing and financing activities can be positive or negative. Thus negative figures have been shown in brackets in above proforma.

METHODS OF PREPARING CASH FLOW STATEMENT

Important changes have taken place in methods of preparing cash flow statement since application of Accounting Standard-3 (Amended). The process of preparing cash flow

statement can be divided into two parts according to method recommended by Accounting Standard-3 (Amended).

- (A) Necessary information
- (B) Necessary steps to be taken for preparing cash flow statement.

Necessary Informations:

For preparation of Cash flow information necessary information can be obtained from the following sources:

- a. Balance Sheets of Two Periods:** Information related to increase or decrease in assets and liabilities can be obtained from balance sheet. Thus, opening and closing balance sheets for the period for which cash flow statement is to be prepared are to be corrected. Cash flow are calculated on the basis of information given in balance sheets.
- b. Profit & Loss account or Income Statement for two periods:** Following informations are obtained from trading, profit & loss account or Income Statement.
 - i. When question is solved through direct method: Information related to purchase, sale and operating items can be obtained through income statement.
 - ii. When question is solved through indirect method: Information related to depreciation, non-cash items and non operating items can be obtained from income statement.
- c. Additional or other informations:** Statement is prepared for sale-purchase of assets, payment of interest, distribution of dividend and other non-cash transactions.

Necessary Steps:

Following steps are taken while preparing cash flow statement:

- (i) Calculation of balances of cash and cash equivalents.
- (ii) Calculation of cash flow from operating activities.
- (iii) Calculation of cash flow, from investing activities.
- (iv) Calculation of cash flow from financing activities.
- (v) Calculation of net increase or decrease in cash from above mentioned three activities.
- (vi) Matching of opening and closing balances of cash and cash equivalents; difference between these balances is equal to net increase or decrease in cash.
- (vii) Presenting non-cash transactions as comments.

CALCULATION OF BALANCES OF CASH AND CASH EQUIVALENTS

Opening and closing balances of cash and cash equivalents are calculated in following manner:

	Opening Balance	Closing Balance
Cash in hand	—	—
Cash in Bank	—	—
Short term Investments	—	—
Marketable Securities	—	—
Total	—	—

Important:

If there is only one or two items in cash and cash equivalents then above mentioned calculation is not required.

CALCULATION OF CASH FLOW FROM OPERATING ACTIVITIES

Following methods have been recommended by Accounting Standard-3 (Amended) for calculation of cash flow from operating activities:

1. Direct Method
2. Indirect Method.

1. Direct Method:

In this method, cash receipts from operating activities (Example: Cash sales, amount received from debtors) and cash payments for operating activities (Example: Cash purchase of goods, payment to creditors for goods purchased on credit, payment of wages, payment to employees) are shown. At the end, difference between cash receipts and payments is termed as net cash flow received from operating activities or net cash flow used.

Direct Method:**Calculation of Cash Flow from operating activities:**

Particulars	Amount	Amount
	Rs.	Rs.
Cash Sales		-
Cash received from Customers/Debtors		-
Less : Cash Purchases		-
Cash paid to suppliers/creditors	-	
Cash Expenses (Operating Exp.—Wages, salaries, rent, rates etc.)	-	-
Cash generated from operating activities		-
Less : Income tax paid		
Cash flow before extraordinary items (+) or (-) Extra ordinary items		-
Cash from (used in) operating activities		-

In brief:

Cash receipts - Cash payments = Net cash flow received

Cash payments - Cash receipts = Net cash flow used.

METHOD OF CALCULATING CASH RECEIPTS AND PAYMENTS**Cash receipts from sale (Including received from debtors):**

Amount received from cash sales or debtors is calculated in following manner.

	Rs.	Rs.
Cash Sales (as given in P & L a/c)	-	
Credit Sales (as given in P & L a/c)	-	
Add : Debtors and B/R at the beginning	-	
: Debtors and B/R at the end	-	
Received from Debtors	-	
Generated from Credit Sales	-	-
Total Cash Generated from Sales		-

Important Point:

Gross opening and closing balance of debtors shall be taken. Opening Debtors + Opening Balance of provision for bad and doubtful debts; Closing debtors + Closing balance of Provision for bad and Doubtful Debts. (Bad debts are deducted from amount of debtors).

Formula:

Sales (cash and credit) + Opening Debtors and B/R – Closing Debtors and B/R = Cash generated from sales.

INDIRECT METHOD

Cash flow from operating activities is calculated on the basis of net profit (before taxes and extraordinary items) under Indirect Method.

Use: In Accounting Standard-3 (Amended) no directions have been given to use only any one method out of these two methods (Direct and Indirect) thus, any one of the two methods can be used. Calculation of net cash flow is very easy under indirect method specially, when amount of sales or P & L account is not given is question. This method also clarifies the reasons for differences between net income and net cash flows from operating activities. Today large scale enterprises are using this method only.

Important Point:

- (1) If question does not mention to use one specific method then students are advised to use indirect method. Along with this keeping in view the informations given in questions students will have to decide the method which they will use in solving the question
- (2) Indirect method can be used in all type of question.

Adjustment in net profit:

Items which are used for adjustments in net profit while calculating net flow from operating activities can be divided into following two parts:

- i. Adjustment of non-cash and non-trading items.
- ii. Adjustment of changes in current assets and current liabilities.

ADJUSTMENT OF NON-CASH AND NON-TRADING ITEMS

1. Items to be added back to net profit:

Following are the items which are to be added back to P & L account.

i. Depreciation:

Depreciation is non-cash item, this does not affect cash balance. As amount of net profit decreases due to depreciation is added back to net profit.

ii. Amortisation of fictitious and intangible Assets:

Fictitious and intangible assets are amortised by showing them on debit side of P & L account which decreases the amount of operating profits, but does not affect the cash balance as they are included in the category of non-cash items. Therefore, amount of fictitious and intangible assets amortised is added back to the balance of operating profits. For example - Amortisation of goodwill, amortisation of preliminary expenses, trade mark, patent, discount on issue of debentures and shares.

iii. Loss on sale of Fixed assets: Amount of operating profit decreases due to loss on sale of fixed assets as it is recorded on debit side of P & L account this loss is added to the amount of profit and operating profit is ascertained.

iv. Transfer to Reserves and Provisions: Reserves: General Reserve, sinking fund, reserve fund, contingencies reserves.

Provisions:

Provision for bad and doubtful debts, provision for income tax provision for Proposed dividend, etc. Amount of profit decreases due to above mentioned reserves and Provisions therefore, they are added back to amount of net profit.

(B) Items to be deducted from net profit:

Following non-operating incomes recorded on credit side of P & L account are deducted from net profits while calculating, net operating profits, as due to these items amount of net profits increases. Following are non-operating items:

- (1) Profit on sale of fixed assets.
- (2) Re-transfer of excess reserves and provisions.
- (3) Dividend and Interest received.
- (4) Refund of Income Tax.

ADJUSTMENT OF CHANGES IN CURRENT ASSETS AND CURRENT LIABILITIES

Increase or decrease in current assets and current liabilities affects the cash flow from operating activities. Thus, it is also necessary to adjust the changes taken place in current assets and current liabilities. While calculating cash flow from operating activities. Following in the method of adjusting increase or decrease in current assets and current liabilities in operating profits.

Increase in current Assets:

(A) Items included in current asset: Debtors, stock, bills receivables, prepaid expenses, accrued income, short term investment .etc. are included in current assets.

(Items of cash or cash equivalents are not included in current assets)

(B) Adjustment: To ascertain cash flow from operating activities, increase in current assets is deducted from operating profits (Net Profit-net increases in current assets).

(C) Reasons: Increase in current assets indicates that less cash has been received from current assets; it means less cash inflow from operating activities therefore, increase in current assets is deducted from operating profits.

Decrease in Current Assets

(A) Items to be included in current assets: Debtors, Stock, Bills Receivable, Prepaid Expenses etc.

(B) Adjustment: Decreases in current assets is added to operating profit (Net profit + Net decrease in current assets).

(C) Reasons: Decreases in current asset indicates that amount of cash has been received from current assets, it means, there is more inflow of cash from operating activity. Thus, decrease in current asset is added to operating profit.

Increase in Current Liabilities

(A) Items to be included in current liabilities: Creditors, bills payable, outstanding expenses, income received in advance etc.

(B) Adjustments: Increase in current liabilities is added to operating profit (Net Profit + Net increase in current liabilities).

(C) Reasons: Increase in current liability indicates that less amount has been paid for current liabilities, whereas, amount of credit purchase has increased, operating profit has decreased due to increase in purchases. Therefore, increase in current liabilities is added to operating profits to calculate cash flow from operating activities.

Decrease in Current Liabilities

(A) Items to be included in current liabilities: Mentioned above.

(B) Adjustments: Decrease in current liabilities is deducted from operating profits (Net profit - Net decrease in current liabilities).

(C) Reasons: Decrease in current liabilities indicates that cash payments are being made, consequently there is a outflow of cash. Thus, decrease in current liabilities is deducted from operating profits.

In brief:

- (1) Cash flow from operating activities decrease due to increase in current assets.
Therefore, amount of net increase should be deducted.
- (2) Cash flow from operating activities increase due to decrease in current assets.
Therefore, amount of net decrease should be added.
- (3) Cash flow from operating activities increase due to increase in current liabilities.
Therefore amount of net increase should be added.
- (4) Cash flow from operating activities decrease due to decrease in current liabilities.
Therefore, amount of net decrease should be deducted.

Clarification of change in the value of Outstanding exp. Prepaid exp., Accrual Income and Unearned Income through formula:

(i) Change in the outstanding Exp.:

Formula: Net Profit + Closing Balance of outstanding Exp. - Opening balance of outstanding Exp.

(ii) Change in prepaid Expenses :

Formula: Net Profit + Opening balance of prepaid Exp. - Closing balance of Prepaid exp.

(iii) Change in Accrual Income :

Formula: Net Profit + Closing balance of Accrual Income - Opening balance of Accrual Income.

(iv) Change in Unearned Income :

Formula: Net profit + Opening balance of unearned income - Closing balance of unearned income.

Illustration 1.

(Cash Flows Statement of Partnership firm) Balance Sheets of M/s Rajan and **Ranjan** on 1-4-2011 and 31-3-2012 were as follows:

Liabilities	1-4-2011	31-3-2012	Assets	1-4-2011	31-3-2012
	Rs.	Rs.		Rs.	Rs.
Creditors	40,000	44,000	Cash	10,000	7,000
Mrs. A's Loan	25,000	—	Debtors	30,000	50,000
Loan from Bank	40,000	50,000	Stock	35,000	25,000
Capital	1,25,000	1,53,000	Machinery (Net)	80,000	55,000
			Land	40,000	50,000
			Building	35,000	60,000
	2,30,000	2,47,000		2,30,000	2,47,000

During the year a machine costing Rs. 10,000 (accumulated depreciation Rs. 3,000) was sold for Rs. 5,000. The provision for depreciation against machinery as on 1st April, 2011 and 31st March, 2012 were of Rs. 25,000 and Rs. 40,000 respectively. Net profit for the year 2012 amounted to Rs. 45,000. Prepare cash flow statement.

Solution: Cash Flow Statement (Indirect Method)

	Rs.	Rs.
Cash Flow from Operating Activities :		
Net profit	45,000	
Adjustment for:		
Depreciation	18,000	
Loss on sale of machinery	2,000	
Operating Profit before Working Capital Changes	65,000	
Add : Decrease in Stock (Rs. 35,000 - 25,000)	10,000	
Increase in Creditors (Rs. 44,000 - 40,000)	4,000	
	79,000	
Less : Increase in Debtors	20,000	
Net Cash from Operating Activities	59,000	59,000
Cash Flow from Investing Activities :		
Purchase of Land (Rs.50,000 - 40,000)	(10,000)	
Purchase of Building (Rs. 60,000 - 35,000)	(25,000)	
Sale of Machinery	5,000	
Net Cash used in Investing Activities	(30,000)	(30,000)
Cash Flow from Financing Activities :		
Loan from Bank (Rs. 50,000 - 40,000)	10,000	
Payment of Mrs. A's Loan	(25,000)	
Drawings	(17,000)	
Net cash used in Financing Activities	(32,000)	(32,000)
Net decrease in cash and cash equivalents		(3,000)
Cash and cash equivalents at the beginning of the period		10,000
Cash and cash equivalents at the end of the period		7,000

Notes to the Solution:

Dr.		Capital Account		Cr.
To Drawings (Bal. fig.)	17,000		By Balance b/d	1,25,000
To Balance c/d	1,53,000		By P & L a/c (Profit)	45,000
	1,70,000			1,70,000

Illustration: 2

The following are the balance sheet of J. Ltd. as on 31st March:

	31-3-2012	31-3-2011
Assets :		
Cash	40,000	57,000
Debtors	77,000	64,000
Inventory	1,32,000	1,40,000
Prepaid Expenses	12,140	16,540
Land	1,25,000	1,50,000
Equipment	2,00,000	1,75,000
Accumulated Dep. - Equipment	(60,000)	(42,000)
Building	2,50,000	2,54,000
Accumulated Dep. - Building	(75,000)	(50,000)
	7,01,140	7,60,540
Liabilities :		
Accounts Payable	33,000	45,000
Bonds Payable	2,35,000	2,65,000
Equity Share Capital (Rs. 10 each)	2,80,000	2,50,000
Retained Earnings	1,53,140	2,00,540
	7,01,140	7,60,540

(1) Operating Expenses include depreciation Rs. 70,000 and amortization of prepaid expenses Rs. 4,400. (2) Land was sold at book value. (3) Cash dividend of Rs. 74,290 was paid. (4) Net Income for 2012 was Rs. 26,890. (5) Equipment was purchased for Rs. 65,000 cash. In addition, equipment costing Rs. 40,000 with a book value of Rs. 13,000 was sold for Rs. 15,000 cash. (6) Bonds were redeemed at face value by issuing equity

shares of Rs. 10 each at par. Prepare Cash Flow Statement for 2012 by using Indirect Method (AS-3 (Revised)).

Solution: **Cash Flows Statement (Indirect Method)**
(for the year ended 31st March, 2012)

	Rs.	Rs.
Cash Flows from operating Activities :	(47,400)	
Net loss (Rs. 2,00,540 - 1,53,140)		
Adjustment for: <i>Add</i> : Depreciation	70,000	
Dividend	74,290	
Less : Profit on sale of Equipments	(2,000)	
Operating profit before Working Capital Changes	94,890	
Add : Decrease in Current assets and Increase in Current Liabilities :		
Prepaid Exp. (Rs. 16,540-12,140)	4,400	
Stock (Rs. 1,40,000- 1,32,000)	8,000	
	1,07,290	
Less : Increase in current assets and decrease in current liabilities :		
Accounts Payable (Creditors) (Rs. 45,000 - 33,000)	(12,000)	
Accounts Receivable (Rs. 77 000 - 64,000)	(13,000)	
Net Cash from operating Activities		82,290
Cash Flows from Investing Activities		
Sale of Land (Rs. 1,50,000- 1,25,000)	25,000	
Sale of Equipment	15,000	
Purchase of Equipment	(65,000)	
Net Cash used in Investing Activities		(25,000)
Cash Flows from Financing Activities		
Dividend paid	(74,290)	
Net Cash used in financing Activities		(74,290)
Net Decrease in Cash and cash equivalents		(17,000)
Cash and cash equivalents at the beginning of the year		(57,000)
Cash and Cash equivalents at the end of the year		40,000

Cash Flow from Operating Activities by Using net Profit of the Current Year

	Rs.	Rs.
Cash Flow from operating Activities :		
Net Income of the current year	26,890	
Adjustment for:		
<i>Add</i> Depreciation	70,000	
	96,890	
<i>Less</i> Profit on sale of equipments	2,000	
Operating profit before working capital changes	94,890	
<i>Add</i> Decrease in Current Assets :	4,400	
Prepaid Exp. (` 16,540- 12,140)	8,000	
Stock (`1,40,000- 1,32,000)		
<i>Less :</i> Increase in Current Assets and Decrease in current Liabilities :		
Accounts payable (` 45,000 - 33,000)	(12,000)	
Accounts Receivable (` 77,000 - 64,000)	(13,000)	
Cash from Operating Activities		82,290

Notes to the Solution:
Accumulated Depreciation Account

	Building	Equipment		Building	Equipment
	Rs.	Rs.		Rs.	Rs.
To Equipment a/c	-	27,000	By Balance b/d	50,000	42,000
To Balance c/d	75,000	60,000	By P & L a/c (Rs.	25,000	45,000
	75,000	87,000	25,000 + 45,000 =	75,000	87,000
			70,000)		

Equipments Account

	Rs.		Rs.
To Balance b/d	1,75,000	By Bank a/c (Sales)	15,000
To P&L a/c	2,000	By Dep. a/c	27,000
To Cash/Bank a/c	65,000	By Balance c/d	2,00,000
	2,42,000		2,42,000

Summary:

Cash flow statement is prepared to know the cash position of an organization by comparing various sources (inflow of cash) and Applications (outflow of cash) of cash items. If cash flow statement compares with fund flow statement, fund flow is a wider one because it considers working capital while cash flow statement considers only cash items. Cash flow statement is compulsory as per As – 3 amended up to date. Under As – 3 Cash flow from various activities is calculated.

Self Check Questions:

1. What is Cash Flow Statement? Discuss its main uses and limitations.
2. What do you understand by Cash Flows Statement? How does it differ from Fund Flow statement? Discuss their importance.
3. How will you calculate Cash Flows from Operating activities by Direct Method and Indirect Method? Explain with example.
4. What are the sources and application of cash.

Practical Questions:

1. Construct a Cash Flows Statement of a company from the following information:

Balance Sheet

Liabilities	2011	2012	Assets	2011	2012
	Rs.	Rs.		Rs.	Rs.
Share Capital	35,000	43,500	Plant	15,000	17,000
Retained Earning	15,000	19,500	Building	20,000	16,000
5% Debenture	22,000	22,000	Land	4,000	4,000
Current liabilities	30,000	32,000	Patents	1,000	900
Accumulated Dep.	5,000	2,800	Debtors	10,000	20,700
			Stock	15,000	15,000
			Cash	40,000	44,400
			Discount Debentures	2,000	1,800
	1,07,000	1,19,800		1,07,000	1,19,800

Additional Informations:

(1) Income for the period was Rs. 10,000; (2) A building that cost Rs. 4,000 and which had a book value of Rs. 1,000 was sold for Rs. 1,400; (3) Depreciation charges for the period were Rs. 800; (4) Shares issued amounted to Rs. 5,000; (5) Cash dividend of Rs. 2,000 and share dividend of Rs. 3,500 were declared and paid.

[Ans.: **Cash from Operation:** (Rs. 19,500- 15,000) 4,500 + 2,000 (Div.) + 3,500 (S. Div.) + 800 (Dep.) + 100 (Pat.) + 200 (Dist.) + 2,000 (C.L.) - 10,700 (Drs.) - 400 (Build) = Rs. 2,000;

Investing Activities: Rs. 1,400 - 2,000 = - 600;

Financing Activities: Rs. 5,000 (S.C.) - 2,000 (Div.) = Rs. 3,000;

Cash and Cash Equivalents: Rs. 2,000 - 600 + 3,000 = Rs. 4,400 + 40,000 (of cash) = Rs. 44,400)]

CASH FLOW STATEMENT OF SOLE TRADER AND FIRM

2. From the following Balance Sheet prepare cash flow statement of Mr. Raman:

Liabilities	31-3-2011	31-3-2012	Assets	31-3-2011	31-3-2012
	Rs.	Rs.		Rs.	Rs.
Current Liabilities	70,000	80,000	Cash	10,000	8,000
Loan from H	-	50,000	Debtors	80,000	90,000
Bank Loan	80,000	60,000	Stock	60,000	50,000
Capital	3,00,000	3,08,000	Land	60,000	80,000
			Building	1,00,000	1,10,000
			Machinery	1,40,000	1,60,000
	4,50,000	4,98,000		4,50,000	4,98,000

Additional Informations:

(i) During the year Mr. Raman brought an additional capital of Rs. 20,000 and his drawings during the year were Rs. 62,000. (ii) Provision for depreciation on Machinery - opening balance Rs. 60,000. closing balance Rs. 80,000. (iii) No depreciation need be provided for on other assets.

[Ans.: Cash from Operating Activities Rs. 80,000; Investing Activities Rs. (70,000), Financing Activities Rs. (12,000).